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DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

THE SUBJECT OF DEPOSIT INSURANCE REFORM AS WELL AS THE NECESSARY RELATED SUBJECT OF FINANCIAL INSTITUTIONS SUPERVISION AND TO DETERMINE THE PROBLEMS AND STRENGTHS IN THE CURRENT STRUCTURES

PART II

JANUARY 22 AND MARCH 4, 13, 1986

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CONTENTS

WEDNESDAY, JANUARY 22, 1986

Page
Opening statement of Chairman Garn 1
Opening statements of:
  Senator D'Amato 53
  Senator Mattingly 53
  Senator Dixon 54

WITNESSES

Edward J. Muhl, insurance commissioner, State of Maryland 2
  Three major objectives of the NAIC 2
  Prepared statement 10
    Property and liability guaranty fund 11
    Life and health guaranty fund 13
  Response to written questions of:
    Senator D'Amato 55
    Senator Proxmire 56
John E. Washburn, director of insurance, State of Illinois; representing the National Association of Insurance Commissioners 3
  Problems for the guaranty funds 3
  Ability to recover paid-out claims 5
  Administration centralized 6
  Change in the triggering mechanism 8
  Prepared statement 15
  Response to written questions of:
    Senator D'Amato 55
    Senator Proxmire 56
Kathleen P. Utgoff, Executive Director, Pension Benefit Guaranty Corporation 23
  Prepared statement 23
    Single-employer program 23
    Ability to control claims 24
    Premium needs 24
    Program reforms 25
    Risk-related premium 25
    Multiemployer program 26
    Conclusion 26
  Response to written questions of Senator D'Amato 59
Theodore H. Focht, President and general counsel, Securities Investor Protection Corporation 27
  Funds of $150 million 27
  Actions by the Board of Directors 28
  Prepared statement 31
    I. Introduction 31
    II. The Securities Investor Protection Act 31
    III. Funding the SIPC Program 35
    IV. Conclusion 37
  Response to written questions:
    Senator D'Amato 62
    Senator Mattingly 66
Panel discussion:
  Study on risk-related premiums 41
  Too big to fail mentality 42

Page

Panel discussion—Continued
- Possible solutions for FSLIC problems 43
- Increase of insurer insolvencies 45
- Affordability of insurance 47
- Cyclical swings in insurance 49
- States passed guaranty fund statutes 50
- SIPC procedure in failing broker-dealers 51

TUESDAY, MARCH 4, 1986

Opening statement of Chairman Garn 97
Opening statements of:
- Senator D'Amato 98
- Senator Mattingly 99
- Senator Dixon 99

WITNESSES

George D. Gould, Under Secretary of Finance, U.S. Department of Treasury 99
- Addressing three topics 100
- Growth and diversification of securities 101
- Nonbank banks contribution to consumers 102
- Three-pronged strategy to help S&L's and FSLIC 104
- FDIC needs tools to deal with bank failures 105
- Prepared statement 108
  - I. Services to the public and profitability: The keys to safety and soundness 108
  - II. The problems of the thrifts and FSLIC 110
  - III. Operational deposit insurance issues 114
  - IV. Conclusion 115
  - Table: FSLIC-insured institutions as of September 30, 1985 116

Witness discussion:
- Revolutionary changes in the financial services industry 117
- Broaden the list of S&L acquirers 118
- Favor expanded services for everyone 119
- Willing to participate in great specificity 120
- Opposed to closing nonbank bank loophole 122
- Adequately valuing assets 124
- Treasury's views on H.R. 3838 125
- Possible flight of thrifts to FDIC 126
- Response to written questions of:
  - Senator Garn 157
  - Senator Proxmire 161

Robert L. Clarke, Comptroller of the Currency 127
- Change is the key to maintaining integrity of the system 127
- Technology in banking 129
- Need of comprehensive legislation 131
- Prepared statement 132
  - Inconsistencies in the regulation of financial services 133
  - Changes in the financial services environment 134
  - Changes in market structure 136
  - The need for banks to adapt 138
  - The need for Federal action 140
  - Expanded bank activities 141
  - Streamlining 141
  - Concerns about greater bank flexibility 141
  - Conclusion 144

Witness discussion:
- Streamline the National Bank Act 145
- Nonbank bank charter applications 146
- Bank failures 148
- Injunction still standing 150
- Allow free market to operate 152
- Effects of drop in oil prices 153
- Possible bank failures 154
- Commercial paper activity 155

Witness discussion—Continued | Page
- Response to written questions of:
  - Senator Garn 184
  - Senator Proxmire 189

THURSDAY, MARCH 13, 1986

Opening statement of Chairman Garn 203
Opening statements of:
- Senator Proxmire 204
- Senator D'Amato 251
- Senator Dixon 260

WITNESSES

Edwin J. Gray, Chairman, Federal Home Loan Bank Board 204
- Reflection of the FHLBB 205
- Would not require taxpayer funds 206
- Great profitability for the S&L's in 1985 207
- Prepared statement 208
  - I. Introduction 208
  - II. Recapitalization 209
  - III. Bank Board response to existing legislative proposals 212
  - IV. Bank Board initiatives to strengthen thrifts and the FSLIC 213
  - V. Other Bank Board legislative proposals 217
  - VI. Conclusion 221
  - Appendix A: Letter to Craig Simmons from Chairman Gray 221
  - Appendix B: Evaluation of the Net Worth Certificate Program 223
  - Appendix C: Mutual-to-Stock conversions 224
  - Appendix D: FSLIC insured institutions 225
  - Appendix E: Specific questions posed by the Committee on Banking, Housing, and Urban Affairs 225
- Response to written questions of:
  - Senator D'Amato 275
  - Senator Proxmire 285

William Seidman, Chairman, Federal Deposit Insurance Corporation 233
- Urgent need for selective changes 233
- FDIC needs flexibility on failed institutions 234
- FDIC fund remains high 235
- Prepared statement 237
  - Banking system problems 237
  - Deposit insurance 238
  - Fairness issue 239
  - Modified payoff 240
  - Disposition of failed bank assets 243
  - Large bank failures 244
  - Risk-related deposit insurance premiums 246
  - Independent bank supervisory system 248
  - Financial condition of the FDIC 249
- Response to written questions of:
  - Senator Garn 287
  - Senator D'Amato 292
  - Senator Proxmire 300
  - Senator Baucus 303
  - Senators Zorinsky, Boren, Exon, and Harkin 316

Panel discussion:
- Nonbank bank loophole 252
- Capital requirements for banks 253
- Restrictions on branching 254
- Rising bank failures 255
- Southwest regional problems 256
- Vital need for S&L's 256
- Higher premiums for risk-related banks 258
- Initiatives to help restructure Third World loans 259
- GAO report on the thrift industry 261
- Depositor preference statute 262
- Thrifts made 55 percent of Nation's mortgages 264

Page
Panel discussion—Continued
- Adopted tougher regulations in 1985 266
- Chairmen of the FSLIC and FDIC are to be commended 267
- Some State laws endanger the system 269
- Possible OMB jurisdiction 270
- Interstate banking 271
- Effects of the tax reform bill 272

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Bankers Association for Foreign Trade, letter to Chairman Garn 322
Chicago Mercantile Exchange, letter to Chairman Garn 340
National Committee on Insurance Guaranty Funds, report on State insurance guaranty funds and insurance company insolvency assessment information, 1969-84 351
Suburban Bancorp, Inc., statement relating to Federal deposit insurance 389
Letter from Senator Garn to H. Brent Beesley, First Charter Savings Bank 398
Response to letter of Senator Garn from H. Brent Beesley 400
A report to the Senate Banking Committee entitled "Current Value Accounting" 401

DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

PART II

WEDNESDAY, JANUARY 22, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today we continue the series of oversight hearings which began last year on deposit insurance reform and financial institutions supervision. During the course of these hearings, the committee has examined the assumptions underlying deposit insurance and has scrutinized the existing system to determine if it has functioned as intended. Throughout the process, our goal has been to guarantee the safety and soundness of the financial intermediary system. Clearly, an effective deposit insurance system is the bedrock of confidence in our banking system and plays an important role in ensuring safety and soundness. The review of this subject deals with very complex and difficult issues. Nonetheless, the committee has approached these oversight hearings with an open mind in our effort to ensure the most effective and efficient financial intermediary system.

This morning we will examine entities other than the FDIC and the FSLIC which protect customers of other financial intermediaries. We will hear testimony from the Securities Investor Protection Corporation [SIPC] whose primary function is to provide financial protection for the customers of failed securities firms, the Pension Benefit Guaranty Corporation [PBGC], who protects the retirement income of participants and beneficiaries of pension plans, and the National Association of Insurance Commissioners [NAIC], which is an organization of and for the chief insurance regulatory officials for the States. Obviously, our purpose in requesting testimony from these groups is to determine what lessons can be learned from their operations and experience, and applied to the FDIC and the FSLIC.

We are pleased to have a very distinguished panel with us today. Ted Focht is representing SIPC, Dr. Kathleen Utgoff from the Pension Benefit Guaranty Corporation, and Edward Muhl and John Washburn on behalf of the National Association of Insurance Commissioners.

We appreciate your willingness to be here and if you would come to the witness table now we would appreciate it.

Senator Proxmire, do you have any opening remarks you wish to make?

Senator PROXMIRE. No, Mr. Chairman.

The CHAIRMAN. Senator Cranston.

Senator CRANSTON. I do not.

The CHAIRMAN. Mr. Muhl, if you would like to begin, please.

STATEMENT OF EDWARD J. MUHL, INSURANCE COMMISSIONER, STATE OF MARYLAND

Mr. MUHL. Thank you, Mr. Chairman. My name is Ed Muhl. I'm the insurance commissioner for the State of Maryland. I am not only the insurance commissioner for the State of Maryland, Mr. Chairman; I am also the vice president of the National Association of Insurance Commissioners. With me today, as you indicated, is the director of insurance for the State of Illinois, John Washburn, and we have with us as well Jim Schacht, also of the Illinois department.

On behalf of the NAIC, we very much appreciate the opportunity to appear before you and to offer some comments and thoughts with reference to the guaranty fund mechanisms that have been created in the various States for insurance purposes.

Just to give you a little bit of the background, Mr. Chairman, the National Association of Insurance Commissioners is an organization of all the chief insurance regulatory officials of the 50 States, the District of Columbia, and the 4 U.S. territories.

The business of insurance, as I'm sure you realize, is primarily regulated by the States and the NAIC provides a forum for the exchange of ideas and the formulation of a uniform policy on various matters that we deal with on insurance.

THREE MAJOR OBJECTIVES OF THE NAIC

There are three major objectives of the NAIC or serve as a framework, if you will, for the organization's activities. These three objectives are: maintenance and improvement of State regulation of insurance in a responsive and efficient manner; reliability of the insurance institution as to financial solidity and guaranty against loss; and fair, just, and equitable treatment of policyholders and claimants.

In achieving these objectives, the NAIC has adopted model legislation to create a mechanism for payment of claims in the event of insurer insolvencies. The purposes for and the working of the State guaranty funds will be discussed in some detail and either Jim Schacht, John Washburn, or myself are available to answer any questions that you might have with reference to the detail.

The NAIC has created two separate model legislation—pieces of legislation, one for the property casualty industry and the other for the life and health industry. They differ in scope and operation.

The NAIC adopted a resolution in May 1969, recommending that each State set up a program by means of a postassessment insolvency fund which was to promote the establishment of a guaranteed payment mechanism of claims of insolvent insurers. The resolution was prompted by NAIC studies in the late 1960's addressing the problems foreseen by a rash of insolvencies by personal lines automobile insurers. We have, as I say, created two guaranty fund mechanisms. The one for the property casualty insurers, there are approximately 47 States that have adopted that model for the property casualty, California and Wisconsin having statutes that were enacted just prior to 1969 but resemble the model, and New York has a preassessment insolvency fund that's been around for quite a few years. It was created in 1947.

The life and health counterpart of this guaranty fund of the property and casualty guaranty fund was—the model legislation was adopted in 1970 and there are presently 38 States that have a life and health guaranty association.

I would like to, if I may, Mr. Chairman, turn it over to Director Washburn for some comments.

JOHN E. WASHBURN, DIRECTOR OF INSURANCE, STATE OF ILLINOIS; REPRESENTING THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Mr. **Washburn**. Thank you, Mr. Chairman. I appreciate the opportunity to appear in front of you today. I have brought Jim Schacht because he has dealt with guaranty funds probably longer than he would like to admit and he understands some of the ramifications of what has happened.

I am not only the director of insurance for the State of Illinois, but I am also chairman of the task force at the NAIC on guaranty funds and Commissioner Muhl has set a framework and I would like to just expand a little bit on the guaranty funds themselves and what we have found.

The guaranty fund framework we have set up has a postassessment framework. Basically after insolvency occurs, the guaranty fund mechanism is triggered and it assesses insurance companies usually based on their premium volume within the States to pay for insolvent insurance carriers and this system for property casualty guaranty funds has worked well ever since 1969. The life fund is relatively new and it's really not had that much practice but when it did come in some strains appeared. Actually strains appeared in both guaranty funds.

PROBLEMS FOR THE GUARANTY FUNDS

The first was the products that the insurers were selling had changed radically since when the guaranty funds were first put together. The insurers were constantly expanding the types of products that they were selling and they had taken a great deal of change.

The second was the insurance marketplace had changed since the guaranty funds were put together. They had changed in a way that we had not anticipated when we first put the guaranty funds together.

Third, we found in the operation of the life and health guaranty fund there were some problems that we had not anticipated when we had first put it together.

So about 2 years ago, a group was formed at the NAIC to address the guaranty funds, to make some changes in them. As Commissioner Muhl stated, there are basically two funds. They work on postassessments and they have a maximum assessment per State so that they do not impinge on the vitality of the remaining industry.

The property casualty guaranty fund model was adopted in 1969 and while it was broadly written from coverage standpoints, the underlying intent was to protect the individual, the small consumer or the small businessman, the so-called unsophisticated insurance buyer.

The particular insurance problems of those days actually happened to that small buyer. They were small auto carriers that basically went insolvent. That is not the case today. Right now the type of insurance company that is going insolvent is usually a much larger insurance company and it handles not only small individual risks for small businesses but also large commercial buyers. So the field that the guaranty fund has gone into is actually very different from the field that was envisioned when it was put together.

The products sold have also changed and the insurance industry—the property and casualty insurance industry right now is going into financial guaranty insurance where they are basically a protection of investors and others in case of default.

Now the changes really brought up questions as to the need and propriety of the protections that the guaranty funds provided. Insurance companies pay for this guaranty fund mechanism for the misfortunes and mismanagements of their competitors, usually competitors who have taken their clients. In doing so, they pass these costs along to all insurance buyers. So basically, the homeowner insurance buyer or the individual auto insurance buyer is helping pay for these guaranty fund protections.

In the case of life and health guaranty funds and in some cases on the property and casualty guaranty funds, there is also a tax offset that the companies are able to use depending on the amount they have been assessed in a particular year. So in a way, all the taxpayers are paying for the guaranty fund protections that are out there.

Well, what that brought up was a question of what coverage should be out there. Should there be restrictions on guaranty funds, especially in regard to large, sophisticated insurance buyers? What should be happening?

The answer to that question was in some cases, yes. Last year on the property and casualty guaranty fund we made some changes. Before I comment on that, let me tell you that the funds are set up with caps on them. In other words, there has been a $300,000 cap usually in all three different lines. The lines were auto insurance, workers compensation insurance, and all other insurance. So they had groups everything else under that. And the caps we're basically looking at were protecting the small buyer, the person who usually had a claim that may mount up to $300,000.

What we did in Reno at our annual NAIC meeting was change the property and casualty guaranty fund model and we now exclude financial guarantees. Basically what we did was remove from the scope of coverage certain types of insurance that protect investment on financial risk.

The focus then of the coverage is still on the property and liability side and that's where we thought it ought to be.

We also removed from coverage any claim which clearly includes an amount awarded as punitive or exemplary damages or a claim sought under a return of premium under a retrospective rating plan. The purpose of this change corresponds to the original intent of the act which is to provide coverage for any actual losses that had occurred. With regard to return premiums, the retrospective rating plan basically looked at how well the company did and it was like a return of premium. It became very different from both a management standpoint but also the standpoint of whether it was paid for actual loss as to whether those premiums should be returned.

The limitation on coverage, the $300,000 limitation on worker's compensation insurance coverage was deleted under this act. The $300,000 limitation made sense under the auto or some of the all other, but in an actual sense that cap made no sense for workers compensation insurance. So if a company had an insolvent carrier covering a workers compensation, if that carrier went insolvent, those claims would continue to be paid by the guaranty fund as long as they came in.

Coverage for unearned premium—in other words, the amount of money which should go back to the policyholder because he no longer has coverage—is now limited to $10,000. The rationale behind this was you were protecting the small person. This change would basically only affect large commercial buyers who spend a great deal of money on insurance in 1 year.

ABILITY TO RECOVER PAID-OUT CLAIMS

The guaranty fund will now have the ability to recover from persons and corporations having a net worth of $50 million to pay for a claim of a corporation having a net worth of $50 million they would pay the claim but they would have the ability, if they so desire, to go back and re-collect that from the company.

Last, but not least, the guaranty fund would no longer pay for a claim of a parent of an insurance company who went insolvent. In other words, if a parent set up a captive insurance company and that insurance company went insolvent, the guaranty fund would not be responsible for those claims.

The thought process behind that was that the parents of the subsidiary insurance companies should certainly know what the company is doing, how well the company is doing, and whether they should be buying insurance from them.

The second thing is there may not be arm's-length transactions in terms of the price of the insurance's cost. So we excluded that from coverage.

Now the life model basically had a different genesis, a different start, from the property and casualty model. It was put together in the early 1970's when there was no clear consensus that it was ever going to be needed. In those days life and accident health insurance companies rarely went insolvent. They were a very good business to be in. There was certainly no consensus in the industry that it would ever be used and there was not a clear consensus among many of the commissioners. There was enough consensus, though, to put together a life and health guaranty fund model.

It was put together a little differently than the property and casualty guaranty fund model. What happens now is if a property and casualty insurer goes insolvent, the policyholders are given up to 30 days to find new coverage. This is because people usually renew on a yearly cycle in terms of property and casualty business. The claims that are presented for that period that they were covered by that company are sent into the receiver and he would ship them out to the State in which the guaranty fund resides. On property and casualty, each State has a guaranty fund and they are responsible for their own individual policyholders. So the receiver would get a claim, he would probably duplicate the claim file, and send it out to the guaranty fund from that State. The domestic commissioner, upon hearing the company had been declared insolvent, triggered the guaranty fund and then receive the claims and pay up to the maximum amount and ship back to the receiver what they had paid on the claims and the receiver would credit whatever else was due against the estate for the final resolution.

In the life model, the whole thought of doing this was not really workable because the product was different. The life and accident and health product was really bought with the thought of continuation of coverage. If you buy your life insurance when you're young, clearly the thought is that if something happens to you in terms of disability that would not make you insurable you still have the ability to buy from that current company. The same is true with the accident and health.

So when we put together the life and health guaranty fund model and the NAIC did this, they included a continuation of coverage under the model. The way that happens is if a life or health insurance company goes insolvent, the guaranty fund basically steps into the shoes of the company. It assumes both the claims and the continuation of the coverage.

ADMINISTRATION CENTRALIZED

But with this continuation of coverage it was not thought that you could allocate among all the different States, so the thought was you had to keep the administration centralized. So in the life guaranty fund model the State of the domiciled insurance company would run the guaranty fund. It would all be run out of a single State. If an Illinois company went insolvent, the Illinois guaranty fund would pay the claims, no matter what State the business was in. If another company went insolvent in a different State that had a guaranty fund they would pay for Illinois claims.

Now as I said, the model was adopted and there was not a clear consensus that it was going to be needed. As a matter of fact, the majority of the industry even when they passed the bill in Illinois they thought it was never going to be triggered and the model also had no incentive for a State with a small domestic industry that didn't have many who were life or health insurers in the State, they were actually being protected by other States. So the model has not been universally adopted. I think there are 38 States that have the model now.

The industry has changed significantly since the early 1970's and with some of the insolvencies some of the problems have manifested themselves.

The first problem was the capacity problem. A Delaware life insurance company, Tara Life, went insolvent. And it had sold business not only in Delaware but in many other States. With the cap on the State assessment in Delaware, and the cap deals with the premium volume in the State of Delaware, capacity problems immediately came to the forefront. They just did not have the capacity to take care of what was going on in the marketplace or take care of all the policies that were out there.

Although the guaranty funds had never been required to perform for Baldwin United, Indiana, where one of the top companies was, estimated it would take 60 years to meet the obligations to all of the policyholders. Baldwin United also pointed out another problem and that is, How do you establish market discipline with a guaranty fund? Policyholders were encouraged to convert their policies from whatever their insurance company was to Baldwin United because they could get a higher interest rate on their annuities and the basic end of that insurance, it was claimed in many cases, was the guaranty fund; that even if it looked like too good a deal, there was a guaranty fund backup.

As the life insurance industry becomes more competitive in market interest sensitive products there were concerns expressed as to what should be the guaranty fund liability with regard to the interest credit by an aggressive company in the marketplace—how do you establish a market discipline, how you make sure people have to look at the company rather than just the interest rate that was being credited.

Also, the insolvencies in the accident and health business, we found the majority of insolvencies were caused because there was no relationship between the cost and benefits provided. So, there was a question as to whether the guaranty fund should be stuck with the continuation when the benefits and the costs had really no relationship at all.

We adopted some changes in December to address these problems. The first change was in the capacity area. With the change in the model act, the State of the policyholder will now take care of that policyholder. It will be like the property and casualty fund model. What that would do is extremely increase the capacity because now each State had a trigger and they could assess for the policyholder and basically it would bring in a great deal more money to take care of any claims that were out there.

So, the model now, when it is adopted by all the States, each State will have to trigger every time there's an insolvency in a life or accident or health company and pay for the citizens of their State and with a premium volume cap it should work out to increase the capacity a great deal.

The guaranty association is now permitted to adjust retroactively and prospectively the amount of interest credited. The adjustment is linked to a standard recognized index. It's basically a Moody's index, so that the insured's funds will be earning a reasonable rate of interest and certainly one close to what they could earn in the open marketplace but not at the excessive rates promised by the insolvent carrier.

What's different is that the guaranty fund will take up a certain part that they will pay and the remaining part of the interest credit will go as a claim against the estate.

The guaranty fund is now permitted to modify prospectively the accident and health insurance contracts in terms of price and benefits. They will pay off the claims of the old contract that were out there, but in the new way the policyholder will have coverage at a reasonable price but the guaranty association will not be required to continue rich coverage at inadequate rates.

CHANGE IN THE TRIGGERING MECHANISM

Also, we have changed the triggering mechanism for the life and health guaranty fund model. Often, when the director or commissioner of insurance wants to declare a company either in rehabilitation or liquidation, there may be a court battle over whether the company should be in rehabilitation or liquidation. In the midst of these court battles it's very difficult to get the claims paid. So, one of the triggers of the guaranty fund can be triggered while the contest over rehabilitation or liquidation is going on. In that way the policyholder can still get his claims covered.

The guaranty fund is also requiring model disclosure of exactly what they cover and what they don't cover, something that is new.

The act explicitly provides for coverage of the unallocated funding agreements, what are called GIC's in the industry. It's an annuity product that is a guaranteed interest account type product.

Although the majority of these changes dealt with capacity—in other words, could the system take insolvencies, especially in the life model we addressed capacity—we are still looking at the capacity of the industry, especially property and casualty.

Nationally it's estimated that this could run to about $1.5 billion a year in assessments. The question is, Is that adequate or what is adequate in terms of the protection that is needed out there for the policyholders. You've really got to look at it in some cases on a State-by-State basis. We could probably not take care of a major jumbo insolvency of one of the carriers in any 1 year, although we have the ability in both property and casualty and life for the estate to pay part of the claims and early access where the receiver can send money to the guaranty fund to help pay the claims.

The guaranty fund also has the ability to borrow against future assessments to take care of the claims.

But it's really not the jumbo insolvency that we are worried about as a likely scenario for insolvencies. What would happen if there were many insolvencies in 1 year of both a medium, a large, and a small carrier? What is the effect on a State. So, for the next year that's basically what we will be looking at in the property and casualty area and looking at some other mechanisms such as preassessment mechanisms both for the need and the feasiblity of it.

In the life model we are basically looking at the annuity account. It's an account that's very fluid in terms of the types of products that are sold. We've got to determine both the capacity to take care of the problems in this account and whether all the products ought to be covered by the guaranty fund. Both studies, of course, have as a goal a workable system for the protection of the policyholders, especially the small policyholder.

Thank you very much.

[The complete prepared statements follow:]

TESTIMONY OF THE

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC)

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

Presented by:

Edward J. Muhl, Insurance Commissioner
for the State of Maryland

and

John E. Washburn, Director of
Insurance for the State of Illinois

January 22, 1986

STATEMENT OF EDWARD J. MUHL

Mr. Chairman and members of the Committee, I am Edward J. Muhl, Commissioner of Insurance of the State of Maryland and Vice President of the National Association of Insurance Commissioners. Appearing with me today is John E. Washburn, Director of Insurance for the State of Illinois and chairman of the NAIC's Guaranty Fund Task Force. We thank you for the opportunity to appear today on behalf of the National Association of Insurance Commissioners.

The National Association of Insurance Commissioners (NAIC) is an organization of and for the chief insurance regulatory officials of the fifty states, the District of Columbia and the four United States territories. The business of insurance is primarily regulated by the states. The NAIC provides a forum for the exchange of ideas and formulation of uniform policy, where appropriate.

These objectives serve as the framework of the organization's activities:

(1) Maintenance and improvement of state regulation of insurance in a responsive and efficient manner;

(2) Reliability of the insurance institution as to financial solidity and guaranty against loss;

(3) Fair, just and equitable treatment of policyholders and claimants.

In achieving these objectives, the NAIC has adopted model legislation to create a mechanism for payment of claims in the event of insurer insolvencies. The purposes for and working of the state Guaranty Funds will be discussed in detail. Since the guaranty mechanisms for the property and liability and life and health insurance businesses differ in scope and operation, the funds will be discussed separately.

Property and Liability Guaranty Fund

The NAIC adopted a resolution on May 19, 1969, recommending that each state set up a program by means of a post-assessment insolvency fund or otherwise, to promote an established means to guarantee the payment of claims against insolvent insurers. The resolution was prompted by NAIC studies in the late 1960's addressing the problem foreseen by a rash of insolvencies by personal lines (automobile) insurers. Prior to the guaranty fund laws, some protection against automobile insurer insolvency had been accomplished by extending the uninsured motorist provision to include coverage against insolvencies. However, all policyholders were not protected.

At the same time that the NAIC identified a need for guaranty fund protection for policyholders, a bill was introduced by Senator Thomas Dodd to establish a federal insurance guaranty corporation patterned after the Federal Deposit Insurance Corporation Act. Senate Bill 2236 was not enacted, however, and the NAIC proceed with adoption of the Model Post Insolvency Assessment Property and Liability Insurance Guaranty Association Act in December 1969.

Following adoption by the NAIC of the model legislation in 1969, 47 states have enacted the model. California and Wisconsin have statutes enacted prior to 1969 which resemble the model. (New York has a pre-assessment insolvency fund enacted in 1947).

The purpose of the NAIC model legislation is: (1) to avoid excessive delay in payment of covered claims; (2) to avoid financial loss to policyholders or claimants because of the insolvency of an insurer by paying claims against insolvent insurers from funds raised through assessment of other insurers; and (3) to assist in the detection and prevention of insurer insolvencies.

These functions are carried out through an insurance guaranty association. All companies authorized to write insurance in the state are required to be members. The nonprofit guaranty association is governed by a board of directors - selected by the insurer members subject to commissioner approval.

After being selected, the board of directors prepares a plan of operation for the commissioner's approval. After adoption of the plan of operation, the guaranty association is inactive or dormant until an insolvency triggers a duty to pay covered claims. Once covered claims from an insolvency are handled, the guaranty fund can return to its dormant state. No administrator or any other employee need be permanently hired.

Some guaranty associations were triggered from their inception and have not experienced a period of inaction. These associations may hire full- or part-time personnel to handle the business of the fund. In some instances, the person handling the affairs is a shared person who also works for other insurance pooling organizations, such as a residual market mechanism.

Other associations hire a full-time manager and, in come cases, there are regional combinations of guaranty associations under one manager. This has occurred in Ohio and West Virginia. The six New England guaranty funds and the District of Columbia have joined under the auspices of the Guaranty Fund Management Service, which is a separate not-for-profit association handling the affairs of those seven guaranty funds. In addition, a fund can handle covered claims by hiring claims people or by hiring the services of an insurance carrier.

The guaranty fund legislation focuses on property and liability coverages and, therefore, exempts insurance deemed to present different problems. Life, title, surety, disability and credit insurance are excluded. The law further precludes from its scope insurance that provides protection for investment and financial risk including financial guaranty insurance.

The guaranty association is required to pay only "covered" claims as defined in the Act. The definition requires that the claim against the guaranty fund be an unpaid claim arising out of, and being within, the coverage and not in excess of the applicable limits of the insured's policy. Furthermore, one seeking payment must either reside in the state at the time of the insured event or the claim must involve property permanently located in the state.

Claimants are paid within certain limitations subject to the following rules:

(1) The full amount of a claim under workers compensation insurance unless for unearned premium.

(2) Up to $10,000 per claimant for return of unearned premium (subject to $100 deductible).

(3) Up to $300,000 per claimant, except that the amount attributable to uneconomic loss is limited to $50,000.

The guaranty associations are funded through assessments to member insurers. The association may assess members up to 2% of their net direct written premiums for the calendar year preceding the assessment to provide funds to pay covered claims.

This Committee requested information about enforcement responsibilities of the state regulators. The NAIC Model Act gives the state insurance commissioners enforcement powers including suspension of a member insurer's license for failure to pay an assessment. As an alternative, the commissioner may levy a fine on any member insurer that fails to pay an assessment when due.

If the maximum assessment does not provide an amount sufficient to cover all necessary payments, the funds available are prorated, and the unpaid portion is paid as soon as funds are available. When paid, the claims will be presented to the liquidator of the insolvent insurer by the association for payment from the assets.

The property and liability guaranty associations are funded on a post assessment basis; i.e., member insurers are assessed after an insolvency occurs. The feasibility of pre-assessment funding is being explored by the NAIC and will be discussed by Director Washburn.

In addition to its responsibility in the event of a member's insolvency, the guaranty association may make recommendations to the commissioner for the detection and prevention of insurer insolvencies and may respond to requests by the commissioner to make recommendations regarding the status of any member whose financial condition may be hazardous to policy holders or the public.

Life and Health Guaranty Fund

Following adoption of the Property and Liability Guaranty Association Model Law, the NAIC appointed a task force to draft guaranty legislation for life and health insurance products. Although there was disagreement between life and health industry representatives and state insurance regulators regarding the need for legislation, the NAIC adopted the Life and Health Insurance Guaranty Association Model Act in December 1970.

The basic purpose of the life and health guaranty associations, as with the property and liability guaranty associations, is to protect policyholders, insurers and beneficiaries against losses due to an impairment or insolvency of an insurer. However, unlike the property and liability relationships, life and annuity contracts are long term arrangements for security. A policyholder may be health impaired or beyond acceptable underwriting age guidelines and, therefore, unable to attain new coverage with the same protections. The payment of cash values does not adequately meet that policyholder's needs; thus, it is essential that the coverages be continued. Similarly, an insurer may be unable to obtain health insurance or may lose protection for preexisting illnesses.

In order to achieve these goals of continuing policyholder protection, the life and health guaranty association has powers to (1) guarantee, assume or reinsure policies of the impaired insurer, (2) provide such monies, pledges, notes, guarantees or other means that are proper to assure payments or (3) loan money to the impaired insurer. These obligations inure to the guaranty association if a petition for rehabilitation or liquidation has been filed or a domestic insurer is under an order of rehabilitation.

Although guaranty associations were created as this Committee states to "manage failure", the provisions cited above extend to impaired insurers. Thus, the members of the state's guaranty association may be working with an insurance commissioner in the effort to rehabilitate a financially impaired insurer.

Protection of the act primarily extends to residents. However, certain nonresidents are protected if the insolvent insurer was domiciled in a state with the Model Act.

The Model Act covers life, health and annuity policies and supplemental contracts. The Model Act applies to direct individual or group certificates issued by member insurers. Thus, self insurers are excluded and reinsurance in general is excluded.

The guaranty association covers, with certain limitations, the lesser of the following:

(1) The contractual obligation of the insolvent or impaired insurer;

or for any one life--

(2) Up to $300,000 in life insurance death benefits, but not more than $100,000 in cash values.

(3) Up to $100,000 in health benefits.

(4) Up to $100,000 in present value of annuity benefits under an annuity which obligates the insurer to pay benefits based on an individually identified life.

(5) Up to $5,000,000 in unallocated annuity contract benefits.

The Association's maximum liability for any one individual is $300,000. These limits may be reached through cash surrender payments, benefit payments or a combination of both. In the case of guaranteed investment contracts where there is no allocation of funds on individual lives, a single benefit may be paid to the group contract holder.

This Committee has asked for data regarding the failure rate of insurer insolvencies for a 5 year period. The NAIC does not collect such data but monitors the statistical information published by the National Committee on Insurance Guaranty Funds (NCIGF), a private association which assists the state property and casualty associations. A copy of NCIGF's latest report is attached for this Committee's review in its entirety. By way of simplified summary the following figures illustrates the Guaranty Association's activity from 1980-84.

	Number of Insolvent property and casualty companies covered by Guaranty Associations	Cumulative Totals for Guaranty Fund assessments collected
1985	20 (estimate)	figures not available
1984	20	528,000,000
1983	4	454,000,000
1982	9	405,000,000
1981	6	332,000,000
1980	4	282,000,000

In 1983, a life and health counterpart, the National Organization of Life and Health Guaranty Associations (NOLHGA) was formed by insurers to provide statistical and educational assistance to the state life and health guaranty associations. Although the data collecting and compilation process has not been completed by NOLHGA, estimates of shortfalls in life and health insurance company insolvencies from 1975 to 1985 are attached.

Recently, Baldwin United's financial problems heightened concern by state regulators as to the capacity of guaranty funds to handle prospective claims. Director Washburn will discuss the NAIC's response to those concerns and discuss the amendments to the NAIC model bills which were recently enacted.

STATEMENT OF JOHN E. WASHBURN

Chairman Garn and members of the Committee on Banking, Housing and Urban Affairs, my name is John E. Washburn. I am Director of Insurance for the State of Illinois. Also, I currently serve as Chairman of the National Association of Insurance Commissioners Task Force on State Insurance Guaranty Funds.

The CHAIRMAN. Thank you, Mr. Washburn.
Dr. Utgoff.

Commissioner Muhl of Maryland has given you a basic overview of state insurance guaranty funds. Therefore, I would like to focus my remarks on the various reforms which have been made recently in the National Association of Insurance Commissioners Model Guaranty Fund laws.

Before doing so, I should note that the NAIC's task force on guaranty funds was first formed approximately two years ago largely in recognition of the fact that reforms were needed. In the main, state insurance guaranty funds have functioned remarkably well since their creation in the late 60's and early 70's. Nevertheless, certain recent events which I shall discuss suggested that certain changes were needed to respond to these emerging situations. As Commissioner Muhl noted, the state insurance guaranty fund system consists of two separate operations, one for the protection of consumers that purchase property and liability type products and the other for those that purchase life and accident and health type products. I would like to begin by addressing the property and liability fund.

The property and casualty post insolvency assessment insurance guaranty fund model law was first adopted by the NAIC in 1969. It was intended to ensure the payment of claims of policyholders and claimants to the limits of the guaranty fund law for an insurance company that became insolvent so that insureds or claimants did not have to wait years until the receivership process was concluded to receive (usually a portion of) their claim. While the model act was broadly written from a coverage standpoint, the underlying intent and purpose was to protect individuals and small businesses or the unsophisticated insurance buyer.

The NAIC model act was developed largely in response to the type of insolvencies that were occurring during the 60's, which generally consisted of small automobile insurance company insolvencies. During more recent times, the types and nature of companies encountering financial difficulties has radically changed to include much larger insurance companies which have insured not only individuals and small businesses but also very large commercial concerns. In addition, the type of insurance products sold by property and liability companies has been changing to include such products as financial guaranty insurance (which protects investors in the event of default) and other products which depart from traditional property and liability insurance.

While there is little question that unsophisticated individuals need guaranty fund protection, significant questions have been raised as to the propriety of protecting large sophisticated commercial insurance buyers as well as investors. While it is relatively easy to justify a system which requires the industry to pay for the misfortunes of their competitors to protect unsophisticated buyers, it is more difficult to rationalize a system which protects sophisticated buyers, thereby not encouraging market discipline that otherwise would be present. Also, because the cost to the industry for guaranty fund payments can be passed on to insurance buyers, it is equally difficult to justify having auto and homeowner insureds paying for claims of investors and large commercial insurance accounts.

This concern provided the impetus for a broad re-examination of the model property and liability guaranty fund law. Before discussing these reforms, I would like to give some background on the life and accident and health insurance guaranty fund model law.

The NAIC model life and accident and health guaranty fund law was created in 1970 and basically serves the same purpose and intent as the property and liability act, namely to ensure the payment of claims of policyholders. The life and accident and health model does have a couple of distinguishing differences, one being that the act requires the continuation of insurance coverage. This is in recognition of the fact that an individual with a long-term disease or impairment may have difficulty in replacing life or accident and health insurance coverage. Also, another distinguishing feature is that the domiciliary state is responsible for covering policyholders of a domestic company wherever the policyholders reside. For example, if an Illinois company failed, the Illinois guaranty association would be responsible for paying policyholders not only in Illinois but also in every state in which the company did business.

Both of these distinguishing features have caused recent problems. Having only one fund responding in the case of a multi-state insolvency has a great impact on capacity. The Baldwin United affair highlighted this capacity problem. While life guaranty associations have not yet been required to perform with regard to the Baldwin United Insurance Companies, the State of Indiana (where one of the Baldwin United life carriers was located) estimated that it would take sixty years for the Indiana Guaranty Association to meet the obligations to policyholders of the Baldwin United Life Company domiciled in that state.

Several recent insolvencies of accident and health insurance carriers have shown that, while continuation of coverage was needed, guaranty funds should have the ability to modify the contract so that the price of the insurance is reasonable in relationship to benefits. One of the causes of the insolvency of A & H carriers has been severe underpricing. It seems inappropriate to require the guaranty fund to continue products at inadequate rates. In addition, with the life insurance industry marketing more interest sensitive products, concerns have been expressed as to what the guaranty associations' obligation should be with regard to these products. If guaranty associations were required to pay high initial and promised interest rates, there would be little incentive for policyholders to seek out sound companies and pass up companies that offered unrealistically high returns. These, as well as related concerns, have resulted in some significant changes in the NAIC model life and accident and health insurance guaranty fund law.

At this point, I would like to review in greater detail the specific reforms which have been recently incorporated in the NAIC's model bill for life and accident and health guaranty associations and the model bill for property and liability insurance guaranty funds. First, with regard to the property and liability model act, the following major reforms have been adopted recently by the National Association of Insurance Commissioners:

(1) The act now specifically excludes any coverage for mortgage guaranty, financial guaranty or other forms of insurance offering protection against investment risk. This exclusion basically removes from the scope of coverage certain types of insurance that provide protection for an investment and financial risk so that the focus of the coverage is for property and liability kinds of insurance.

(2) The act now removes from coverage any claim which includes an amount awarded as punitive or exemplary damages or a claim sought under a return of premium under a retrospective rating plan. The purpose of this change corresponds to the original intent of the act, which is to provide coverage for actual damage or losses. With regard to return premiums, the change will remove from coverage premiums which may be due as a result of a rating plan common in commercial insurance.

(3) The limitation on coverage for workers compensation insurance has been removed so that injured workers whose employer was insured by an insolvent carrier can collect the full amount of the claim from the guaranty fund. Previously this coverage was limited to $300,000. While this limit may have made sense for other forms of insurance, it seemed to be unrealistically low for workers compensation insurance.

(4) Covered claims for unearned premiums are now limited to $10,000. This change will ensure that most unearned premium claims are covered except for the larger commercial risks.

(5) The guaranty fund will now have the ability to recover from persons and corporations having a net worth of $50,000,000 or more for any claims paid by the guaranty fund on their behalf. This provision will require the guaranty fund to pay a liability claim against a multi-million dollar corporation but will allow the guaranty fund to recover the amount paid from such a corporation.

The major reforms to the life and accident and health guaranty association model are as follows:

(1) The major change from the existing model act is a fundamental one which now stipulates that each state guaranty association is responsible for covering its resident policyholders only. This change makes more capacity immediately available because potentially 50 states will now be able to make an assessment rather than just one state where the insolvency occurred.

(2) The guaranty association is now permitted to adjust retroactively and prospectively interest credited on life and annuity insurance contracts. The adjustment is linked to a standard recognized interest index (Moody's Corporate Bond Yield Average) so that the insured's funds will be earning a reasonable rate of

interest and certainly one close to what they could earn in the open market but not at excessive interest rates promised by the insolvent carrier.

(3) The guaranty association is now permitted to modify prospectively accident and health insurance contracts as to price and benefits. In this way, the policyholder will still have coverage at a reasonable price but the guaranty association will not be required to continue rich coverage at inadequate prices.

(4) The point at which the guaranty association is triggered has now been changed so that payments can be made by the guaranty association to policyholders when a petition for rehabilitation or liquidation has been filed in the company's home state. This provision will allow policyholders to receive claim payments while the litigation between the company and the domiciliary regulator over whether or not the company should be rehabilitated or liquidated is taking place.

(5) The Guaranty Association Act now requires disclosure of guaranty fund coverage and limitations to policyholders.

(6) The Act now explicitly provides for coverage of unallocated funding agreements (guaranteed investment contracts and deposit administration contracts). The

amount of coverage is $5,000,000 for each contract holder. The guaranty fund task force currently has the matter of coverage for unallocated funding agreements under further study. This study will focus on two issues, namely, whether a $5,000,000 level of coverage per contract holder is appropriate and if the coverage and assessments should be covered under a separate account or a merged account with other annuities or, perhaps, even combined with the life insurance account.

At this point, I would like to briefly touch on some of the other questions the Committee has raised. First, with regard to the options available to a state insurance commissioner to manage a failure or, in fact, avoid a failure, let me offer only a few comments. I said "comments" because this function - preventing failures and diminishing their impact on consumers - is the prime purpose of insurance regulation and would require a substantial period of time to cover adequately.

With regard to preventing failures, a state insurance commissioner has a variety of surveillance and detection tools available, as well as a full range of statutory options which can be utilized. On site examinations and financial analyses supported by a computerized financial ratio system and data

base are presently utilized to detect financially troubled insurers. Once the problem is identified, the commissioner can take a variety of actions depending on the nature and extent of the problem. These range from ordering the company to take certain corrective actions to petitioning a court to place the company in some form of receivership (whereby the insurance commissioner actually takes control of the company). To supplement the resources of an insurance department to examine, monitor or analyze a company trending toward a hazardous financial condition, it is common to use outside experts such as accountants and actuaries or personnel from other state insurance departments.

In regard to managing a failed insurer, this is done in a variety of ways. In all cases, the insurance commissioner of the domiciliary state is the court appointed receiver. Usually, smaller states will hire an outside consultant such as an experienced lawyer or accountant to manage the rehabilitation or liquidation. Larger states usually have personnel either in the insurance department or in a separate bureau who are skilled in insurance company receivership proceedings, and they are the group which actually manages the receivership. Quite often, because of the complexities involved, other individuals outside the insurance department may be utilized to handle a problem or a special facet of the receivership. Coordination and communication between the states on multi-state failures is done under the auspices of the National Association of Insurance Commissioners.

In regard to the guaranty of property and liability insurance, the system so far has not been severely tested. The system has handled all property and liability insurance company insolvencies to date without delay.

Of concern, of course, is the so-called "jumbo insolvency" or a series of large insolvencies. While it is theoretically possible to exhaust one year's capacity with one insolvency, there are a number of factors which would permit the system to respond.

While an insolvent company by definition will have insufficient assets, it will have some assets. Through early access provisions in most guaranty fund laws, the receiver is directed to provide the guaranty funds with a distribution of funds from the assets of the insolvent carrier, which can be used to reduce guaranty fund assessments or increase capacity to pay claims. Also, the guaranty funds have the ability to borrow money, which would permit meeting current obligations in spite of assessment limitations.

While the NAIC's guaranty fund task force is fairly comfortable that the present system has the capacity to respond, it is currently studying the subject of guaranty fund capacity for property and liability insurers to ensure that the

guaranty fund system can handle most likely scenarios of insurer insolvencies. This study will examine such questions and issues as:

- How much capacity should the guaranty fund system have? Should it be structured to handle a failure of a very large company?
- How adverse an insolvency can the present structure handle? Given the current industry condition, can the present structure handle most likely insolvencies?
- What impact will a sequence of yearly maximum assessments have on the industry and individual companies from a surplus and operational standpoint?
- What assumptions should be utilized for the study? What levels of loss reserve inadequacy and available assets should be presumed? What guaranty fund pay-out patterns for claims should be employed for the study?

In addition, the task force is studying a variety of conceptual changes in the guaranty fund system such as a pre-assessment system and other variations, as well as what steps can be taken to improve the surveillance and solvency regulation of insurers.

Thank you for the opportunity to testify.

The CHAIRMAN. Thank you.

Mr. Focht.

STATEMENT OF THEODORE H. FOCHT, PRESIDENT AND GENERAL COUNSEL, SECURITIES INVESTOR PROTECTION CORPORATION

Mr. FOCHT. Thank you, Mr. Chairman.

SIPC is now entering its 16th year of operations and we are pleased to have this opportunity this morning to review with you our experience to date.

In the 189 customer protection proceedings which we have undertaken in the past 15 years, we estimate that 190,000 customers have received cash and securities with a value of approximately $727 million. Of that amount, approximately $158 million has been advanced from SIPC funds. When combined with SIPC advances which were necessary to pay administrative expenses in those 189 customer protection proceedings, we can report to you that net SIPC advances of approximately $180 million have been used to protect the customers who were dealing with members of SIPC who encountered such financial difficulty that it became necessary for them to cease doing business and close their doors.

We have submitted a formal statement which I understand will be made part of the record.

The CHAIRMAN. That's correct.

Mr. FOCHT. My purpose then will be to summarize two parts of that statement which I believe are of particular interest to your committee this morning.

One is the matter of funding of SIPC and the second is our recent experience with customer protection proceedings.

FUNDS OF $150 MILLION

First, on the matter of funding, Mr. Chairman, the statute requires that SIPC maintain a fund of not less than $150 million or such other amount as the SEC may determine in the public interest. By way of footnote, I would mention that in the 15 years of our existence the SEC has not found it necessary to act pursuant to that authority.

Two and one-half years ago, in September 1983, our Board of Directors reviewed the question of the fund size and for a number of reasons determined at that time to continue the then present assessments of one-quarter of 1 percent of gross revenues from the securities business. Our Board determined to continue those assessments until our fund totaled $300 million.

I would point out that that decision by our Board of Directors resulted in a doubling of the immediately available assets which SIPC would eventually have to carry on its program.

Last summer, the summer of 1985, when we anticipated reaching that $300 million goal by the end of 1985, our directors appointed a task force of representatives from the Government, the self-regulatory organizations, and the securities industry, to consider the SIPC fund size and the SIPC assessment structure and make recommendations to our Board of Directors concerning them.

ACTIONS BY THE BOARD OF DIRECTORS

In November 1985, our Board of Directors, acting pursuant to recommendations made to it by this special task force, took the following actions.

First, the Board directed that the SIPC staff negotiate and present to the Board for its approval a $500 million line of credit with a consortium of banks.

Second, the Board determined that, effective April 1, 1986, the present assessment of one-fourth of 1 percent of gross revenues would terminate. The Board of Directors specifically provided that this termination of assessments based on gross revenues is contingent on the $500 million line of credit being effective and in place by April 1.

Finally, the Board reviewed the SIPC bylaws concerning the amount of assessments which would be levied upon SIPC members in the future. An amended bylaw was approved by SIPC's Board of Directors in November and forwarded to the Securities and Exchange Commission for their approval in accordance with the requirements of SIPA.

I am pleased to report to you that yesterday the Securities and Exchange Commission acted on that filing by SIPC and gave the necessary clearances for that bylaw.

The proposed bylaw amendments will amend SIPC's existing bylaws on assessments as follows: If the fund should ever drop to $250 million, an assessment of one-eighth of 1 percent of gross revenues from the securities business would automatically go back in place. If the SIPC fund should drop to $150 million, an assessment of one-quarter of 1 percent of gross revenues would go into place; and if the SIPC fund should drop to $100 million, an assessment of one-half of 1 percent of gross revenues would go into place.

In addition, the bylaw amendment also provides for a minimum SIPC assessment of $100 per firm per year.

Accordingly, remembering that the statute requires maintaining the fund at $150 million, SIPC as a result of these actions, expects to have as of April 1, 1986, resources exceeding $830 million which could be tapped before any need to draw on the statutory $1 billion line of credit to the U.S. Treasury.

The proposed bylaw, as I've mentioned, provides for automatic reimposition of assessments on gross revenues at any time that the fund would drop below certain levels.

This and the other provisions in the bylaw give SIPC considerable flexibility in maintaining the SIPC fund at a level which we believe is adequate to carry out SIPC's primary goal of enhancing and maintaining investor confidence in the securities market. That flexibility also, we believe, helps to assure that Government funds will not be needed in the future.

By way of footnote, I should also point out that while SIPC has, since the beginning, had a line of credit of $1 billion from the United States, we have never found it necessary to draw on that.

To turn briefly to our customer protection proceedings, Mr. Chairman, as is detailed in my formal statement, SIPC's program is provided to customers of securities firms via a court proceeding which is initiated by SIPC.

Our experience with customer protection proceedings in the last 5 years has shown 7 to 12 new customer protection proceedings per year. This represents approximately one-tenth of 1 percent of the total SIPC membership, which at the present time is about 11,000 members. It compares favorably to our experience in the early years of SIPC, 1971-75, when we were experiencing 15, 24, 30, and in 1 year 40 new customer protection proceedings a year.

While SIPC membership has increased dramatically over the years, the number of firms requiring the initiation of a customer protection proceeding has decreased over the 15 years of our existence and has not increased significantly over our most recent years.

This can be attributed, we think, to a number of factors. The financial responsibility rules which require appropriate segregation of customer assets, the rules concerning the capital structure of our members, the increased internal controls by SIPC members, and the improved surveillance by the self-regulatory organizations and the SEC.

In the securities industry, customer property is protected by the financial responsibility rules and regulations, including particularly rule 15c3-3 promulgated by the Securities and Exchange Commission. That rule requires that broker-dealers take possession of and maintain control of customer securities and restricts the use of customer funds by the broker to the financing of customer receivables and to the deposit of such funds in special reserve bank accounts for the protection of customers. This important rule is designed to protect customers who engage in securities transactions with their broker-dealer by ensuring that the broker-dealer maintains the customers' property in secure circumstances.

In addition, net capital requirements based on liquidity have been in existence in the securities industry for decades. Recent years have seen a strengthening of the standards in this area as well. The rules require broker-dealers to maintain minimum amounts of liquid assets in relation to their aggregate indebtedness and thereby attempt to alleviate the risks presented by potentially illiquid assets.

These requirements, in our judgment, substantially differentiate the securities industry from the banking and savings and loan industry. The customer deposits in banks and savings and loan associations are available for management to lend and invest on a principal basis which sometimes places those customer deposits in illiquid assets.

We believe that continued emphasis on effective self-regulation of the securities industry and early identification of brokers which may be approaching financial difficulty are essential to the SIPC program. SIPC believes that the relatively small number of customer protection proceedings which we have had to initiate in the past 5 years is an indication that this approach is working to identify problem brokers before liquidation is the only alternative left.

When it is necessary to initiate a customer protection proceeding, SIPC has the experience and the resources needed to deal with the matter. We believe the record demonstrates that SIPC, since its inception, has responded efficiently and effectively to the mission that was given to it by Congress. Thank you.

[The complete prepared statement follows:]

STATEMENT OF KATHLEEN P. UTGOFF, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION

Ms. UTGOFF. I am Kathleen Utgoff, Executive Director of the Pension Benefit Guaranty Corporation.

Mr. Chairman:

I am pleased to appear before you today to discuss the two insurance programs administered by the Pension Benefit Guaranty Corporation. Congress created the PBGC in 1974 in response to growing concern that participants in terminated defined benefit pension plans were not receiving the benefits promised by their employers. The PBGC now provides vital insurance protection to about 29 million active and retired workers in nearly 110,000 single-employer plans and to over 8 million people in about 2,500 multiemployer plans.

Each insurance program is financed through premiums paid by plans it covers and investment income. The single-employer program also receives assets from employers that transfer their pension liabilities to PBGC through plan termination. Increases in the premium rates of both programs require congressional approval. The PBGC has a $100 million line of credit with the Treasury, which we used only once -- to borrow $100,000 for start-up money in 1974.

SINGLE-EMPLOYER PROGRAM

Whenever a covered single-employer plan terminates without sufficient assets to provide all guaranteed benefits, responsibility for paying these benefits shifts to the PBGC and thus to the premium payers. The employer sponsoring the plan must reimburse the PBGC for the shortfall in assets but only to a maximum of 30 percent of the employer's net worth. In most instances, employers that terminate underfunded plans have low net worth. As a result the 30 percent of net worth limitation enables PBGC to recover, on average, less than 10 percent of the plan underfunding.

Since plan termination is an option available to all plan sponsors, not just firms in trouble, the term "failure rate" is not applicable to the incidence of PBGC claims. The PBGC has incurred claims from an average of about 100 single-employer plans each year, or approximately 0.1 percent of all covered plans each year. However, the dollar amount of net claims -- which is defined as unfunded guaranteed benefits less recoveries of employer liability -- has increased dramatically during PBGC's short history. During the first four years (July 1, 1974 - September 30, 1978), the average annual net claim was about $35 million; in the next four years it averaged about $116 million. We now estimate our experience for the most recent three calendar years will average about $300 million.

The PBGC does not manage the assets of each terminated plan separately. Rather, assets of terminated insufficient plans are commingled and the PBGC assumes all responsibility for paying guaranteed benefits. A terminated plan ceases to exist as a separate entity.

Ability to Control Claims

Under current law, the PBGC can control neither the incidence nor the size of a claim. The PBGC has no regulatory authority over ongoing plans. Certain provisions administered by other agencies -- fiduciary standards by the Department of Labor and minimum funding standards by the Internal Revenue Service -- can have an effect on the size of claims.

The PBGC must accept any valid termination. A company may terminate a pension plan at any time, even if the business continues. About 20 percent of our net claims have come from ongoing companies that are not in any type of bankruptcy proceeding, yet these companies often have taken advantage of the 30 percent of net worth cap to dump their pension liabilities onto the PBGC.

The size of a claim depends, in the first instance, on the value of unfunded guaranteed benefits in the plan. Plans are required to meet minimum funding standards, but compliance with those standards does not necessarily guarantee that a plan will be fully funded upon termination. The funding standards permit amortization of certain liabilities over periods as long as 30

years; as a result, in extreme cases, the plan may never make reasonable progress toward full funding. In one recent case, the PBGC incurred a $165 million claim from a plan that had existed for over twenty years and appeared to satisfy the minimum funding standards. Nevertheless, at the time of termination, the plan had assets equal to only two months' benefit payments.

Also, plan sponsors in financial difficulty can request waivers of the minimum funding standards from the Internal Revenue Service. A waiver provides extended payment terms for required contributions. The IRS notifies the PBGC of large pending requests and places restrictions on the waivers to protect the PBGC. However, these restrictions often prove insufficient. Funding waivers are really unsecured loans to troubled firms. Recovery on these loans is very low. About one-fifth of the program's deficit can be attributed to funding waivers that were not repaid.

Premium Needs

The single-employer premium, currently $2.60 per participant per year, has not changed since 1978. Premium revenues since then have run about $70 to $80 million per year. Based on our recent claims experience, we now estimate that benefit payments for FY 1986 will equal approximately $270 million -- an increase of $100 million over actual benefit payments in FY 1985. Total liabilities of the Corporation have increased seven-fold over the last seven years.

Each year since 1982, the Administration has requested a premium increase. Last year, the Administration proposed a premium increase to $7.50 per participant per year, effective January 1, 1985. The equivalent, effective January 1, 1986, would be $8.10. The requested increase was based on a forecast that claims against the PBGC would average $185 million annually over 15 years. These assumptions led to a projected FY 1985 year-end deficit of $583 million.

The single-employer program experienced unexpected and extraordinary losses in FY 1985. Two cases, by themselves, accounted for net claims in excess of $600 million; before then, our largest individual claim had been approximately $60 million.

The actual single-employer deficit as of September 30, 1985, will be reported at $1.3 billion, more than double the projected figure. We are now in the process of analyzing the impact of the FY 1985 claims experience on our premium needs. Clearly, the current $2.60 premium is too low to sustain the program. A premium increase to $8.50 per participant is included in the Conference report on H.R. 3128, the reconciliation legislation now pending in the Congress.

Program Reforms

Along with its premium request, the Administration has proposed program reforms that are desperately needed to assure that PBGC can continue to provide the retirement security that Congress intended when it created the program. Briefly, these reforms would

- limit access to PBGC insurance funds to cases of employer financial distress;
- increase the amounts owed to the PBGC by employers that terminate underfunded pension plans; and
- require security in favor of the plan as a condition for granting a minimum funding waiver.

The Conference Report on H.R. 3128 includes a compromise reform package as well as a premium increase.

Risk-Related Premium

Many groups have expressed dissatisfaction with the current flat rate premium. Sponsors of well-funded plans complain that they should not be forced to subsidize their competitors that have underfunded plans. The current system is not only unjust but it is also bad for the economy because it subsidizes failing, inefficient companies. In 1980 Congress required that the PBGC study the issue of a risk-related premium and report back its findings. We expect to complete this study after the single-employer bill has been enacted.

MULTIEMPLOYER PROGRAM

The smaller and less troubled multiemployer insurance program, which Congress significantly restructured in 1980, covers collectively bargained plans sponsored by two or more unrelated employers usually, but not always, in the same industry. Claims arise under this program when a multiemployer plan does not have enough assets to continue paying benefits to retirees at the PBGC-guaranteed level. The PBGC provides financial assistance in the form of loans to the plan, so that the plan can meet its current obligations and avoid insolvency. This financial assistance must be repaid if the plan is able to do so. Currently, the PBGC is providing assistance to 3 plans.

The 1980 amendments contained several provisions designed to limit claims under the multiemployer program. An employer that withdraws from a multiemployer plan is required to pay to the plan its pro rata share of the plan's unfunded vested benefits. Poorly funded multiemployer plans must in some cases increase required employer contributions. If such a plan becomes insolvent, it must, in addition, suspend payment of certain benefits that are not guaranteed by the PBGC.

The current multiemployer premium is $1.80 per participant per year. That will rise to $2.20 in September 1986 and to $2.60 in September 1988 as provided in the 1980 amendments. As of September 30, 1985, the multiemployer program had a surplus

of $26.7 million. The PBGC recently submitted to Congress a study of the multiemployer program's financial needs over the next five years that concluded that no premium increases beyond those mandated by statute would be necessary during this five-year period.

Conclusion

Thank you, Mr. Chairman, for the opportunity to testify today. I will be happy to answer any questions that you and the Committee members may have.

Statement of

Theodore H. Focht
President and General Counsel
Securities Investor Protection Corporation

before the

Senate Committee on Banking,
Housing and Urban Affairs

on

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I

Introduction

The Securities Investor Protection Act ("SIPA")[1] was enacted on December 31, 1970 in the wake of numerous failures of broker-dealer firms in the latter part of the 1960s and 1970. SIPA was enacted to provide to customers of securities broker-dealers protection against certain losses which might occur as a result of the financial failure of the broker-dealers. This overview is designed to provide an outline of the general history of the legislation and the operation of the program created by SIPA.

II

The Securities Investor Protection Act

Prior to 1938, customers of a bankrupt stockbroker were treated as general creditors if they could not reclaim cash and securities which they could trace into the stockbroker's possession.[2]

In 1938, Congress enacted section 60e of the Bankruptcy Act[3]. This section carefully defined "customers" and "cash customers" and permitted the latter to reclaim cash or securities which could be specifically identified as their property. Otherwise, it provided that cash or securities which were held for the account of customers (but not specifically identifiable to particular cash customers) would constitute a "single and separate fund" to be applied pro rata in satisfaction of customers' claims as a "single and separate class of creditors," in priority to claims of general creditors. A customer's share of the single and separate fund was based on the "net equity" of his or her securities account. As for the unpaid balance of their net equities, customers shared with general creditors in the general estate.

Because of the usually inadequate single and separate fund, section 60e did not prevent customer losses. Customer exposure mounted when the rate of stockbroker failures accelerated in 1969 and 1970. The Congress responded by enacting SIPA whose several purposes were stated thus in the Senate Report:

> "... to protect individual investors from financial hardship, to insulate the economy from the disruption which can follow the failure of major financial institutions; and to achieve a general upgrading of financial responsibility requirements of brokers and dealers to eliminate, to the maximum extent possible, the risks which lead to customer loss.[4]

SIPA accomplished these purposes by two methods. First, it enhanced the power of the Securities and Exchange Commission ("SEC") to establish financial responsibility rules for brokers and dealers. SIPA also imposed requirements on the self-regulatory organizations, such as the stock exchanges and the National Association of Securities Dealers for the financial examination of their members. Second, SIPA created the Securities Investor Protection Corporation ("SIPC") and, among other things, established procedures for liquidating financially troubled broker-dealers who are members of SIPC.

SIPC and Its Funds

SIPC is a non-profit membership corporation whose members include most interstate broker-dealers. Membership in SIPC is not voluntary and is predicated upon registration as a broker or dealer with the Securities and Exchange Commission under section 15(b) of the Securities Exchange Act of 1934.[5] Firms which deal exclusively in the distribution of mutual funds or variable annuities are not statute made members of SIPC. Also, brokerage firms which deal exclusively in "exempted securities" are not required to register as broker-dealers under the securities Exchange Act of 1934, and consequently those firms are not members of SIPC. The term "exempted securities" is defined in 15 U.S.C. section 78(c)(12) to include "securities which are direct obligations of, or guaranteed... by the United States." Mortgage backed securities issued by the Federal Home Loan Mortgage Corporation, although not directly backed by the United States, are also "exempted securities." 17 C.F.R. section 240.3a12-1.

SIPA requires SIPC to establish a fund via assessments upon its members.[6] SIPC has operated since its inception without the expenditure of Federal funds. However, should SIPC's funds become inadequate, SIPA authorizes a borrowing against the U. S. Treasury of up to one billion dollars.[7] These resources are available for the satisfaction of claims of customers within the limits mentioned below.

Nature of a SIPA Proceeding

A proceeding under SIPA is a liquidation proceeding.[8] In addition to his or her powers under SIPA, the trustee has the same powers and title with respect to the debtor and the debtor's property as a trustee in bankruptcy, including the right to avoid preferences.[9] SIPA does not attempt to make all customers whole and SIPC's role is carefully delineated. It contemplates that customers' claims will be satisfied to the maximum extent possible from the assets of the defunct member firm. SIPC's funds supplement those assets within the limits and in the manner provided by the statute. The proceeding looks not only to the claims of customers, but also the claims of general creditors.[10]

A SIPA proceeding is initiated in a United States District Court.[11] Only SIPC may initiate such a proceeding; an aggrieved customer or other creditor cannot do so.[12] If the District Court grants SIPC's application for a "protective decree," the court will also appoint as trustee, and counsel to the trustee, persons specified by SIPC.[13] The entire liquidation proceeding is then automatically removed to the United States Bankruptcy Court in the same judicial district.[14] The Bankruptcy Court is then responsible for the actual conduct of the liquidation. Recently, there have been challenges to the Bankruptcy Courts' jurisdiction over all or part of a SIPA proceeding. The Congressional intention to have a Bankruptcy Court preside over a SIPA liquidation was made clear in 1978. However, subsequent legislation amending the Bankruptcy Code in 1984 has led to confusion in this area, and legislation to clarify this point would be useful to SIPC.

Customer Claims Under SIPA and the Use of SIPC Funds

The definitions of "customer" and "net equity" and other operative provisions of SIPA are derived from former section 60e.[15] It has been said that SIPC is an "engraftment of insurance provisions" upon the preexisting framework of former section 60e,[16] although SIPC does not "insure" broker-dealers in the true sense of the term.[17] SIPC's funds merely augment the fund of "customer property"[18] in which all customers share ratably to the exclusion of general creditors.

SIPC may advance not more than $500,000 for each customer for the amount by which such customer's "net equity"[19] exceeds his ratable share of customer property, and in no event more than $100,000 for that portion of a claim which is for cash.[20] Thus, regardless of the assets of the failed firm, each customer with a valid claim is assured of satisfaction within the limits indicated. Significant protection is thus afforded to persons whose claims qualify as claims of "customers" within the statutory definition. The availability of SIPC's funds does not, however, lessen the burden of customers' claims on the estate or its general creditors. To the extent of its advances, SIPC is subrogated to the claims of such customers.[21]

In 1978, SIPA was amended to provide greater flexibility to SIPC. While the Senate Report concerning the amendments stated that SIPA had "demonstrated considerable success since its enactment in 1970"[22], the amendments were necessary to further the goal of satisfying customer claims in an expeditious fashion. The essential elements of a SIPA proceeding remained the same. In particular, there were no material alterations to the definition of a "customer" with the exception of codifying elements of case law. The concept of a "single and separate fund,"

which had been derived from section 60e(2) of the Bankruptcy Act, was altered to a fund of "customer property";[23] the fund of "customer property" encompassing a somewhat broader range of assets than the former "single and separate fund." Similarly, the concept of "specifically identifiable property" was altered to "customer name securities";[24] "customer name securities" encompassing a narrower range of assets than the former "specifically identifiable property." The legislative history of the amendments explains the change:

> §16(3) of the Act — "Customer name securities" takes the place of "specifically identifiable property" as the category of securities which will be returned to individual customers outside the normal procedure for allocating and distributing customer property. Securities registered in the names of customers or in the process of being so registered on the filing date will be treated, in short, as though they are not part of the debtor's estate, but merely held by the debtor as bailee. Excluded from this definition are securities in negotiable form, for example, securities registered in customer name but for which the customer has signed stock powers.
>
> §16(4) of the Act — This section defines "customer property," the concept which takes the place of the "single and separate fund" of SIPA as now in effect. Customer property, briefly explained, consists of all cash and securities (other than SIPC advances and customer name securities) available to the trustee for the satisfaction of customer claims. It includes all cash and securities held from or for the accounts of customers, including the proceeds of any such property transferred or unlawfully converted.[25]

The legislative history demonstrates that only securities registered in the name of a specific customer are subject to reclamation,[26] and that all cash or free credit balances in a customer's account representing cash are part of "customer property."

Direct Payments Under SIPA

The 1978 amendments also authorized a "Direct Payment Procedure," an additional tool to expedite satisfaction of customer claims. If SIPC determines that a member otherwise meets the prerequisites for initiation of a liquidation proceeding, but the claims of the member's customers aggregate less than $250,000, are all within the limits of protection, and either the member's registration has been revoked or the member has consented, SIPC may institute a direct payment procedure.[27/] In such cases, and only in such cases, claims are filed directly with SIPC.[28/] The customer protection and subrogation provisions are substantially the same as in a liquidation proceeding.[29/] There is, however, no provision for the complete liquidation of the member. The direct payment procedure, which proceeds outside the supervision of any court, includes no provision for handling general estate claims. Aggrieved customers may seek review of SIPC's determination of their claims by applying, within six months of SIPC's determination, to the court having jurisdiction of cases under Title 11 where the member's head office was located.[30/] Use of the direct payment procedure also reduces the administrative costs in small liquidations.[31/]

Summary of Customer Protection

When a SIPC member (sometimes hereinafter "debtor") is placed in liquidation under SIPA, or is the subject of a direct payment proceeding under SIPA, each separate customer of the debtor is protected as follows:

(1) Each customer receives all "customer name securities" the debtor has for his account, without regard to amount or value.

(2) Each customer receives a ratable share of the fund of "customer property" of the debtor's estate.

(3) To the extent that a distribution of "customer name securities" and "customer property" is insufficient to make each customer whole, SIPC will advance to the trustee up to $500,000 for each customer, of which sum a maximum of $100,000 can be for a cash balance owed to the customer. To the maximum extent practicable, the trustee will use the funds so advanced to buy securities of like class and series of an issuer , so as to make each customer's portfolio whole.[32/] To the extent the trustee is not able to buy securities to replace shares which are missing, the customer receives the value of those securities on the filing date.[33/]

(4) To the extent the customer is still unsatisfied, he is entitled to participate in the general estate of the debtor as an unsecured creditor.[34/]

While every effort is made to satisfy customer claims as rapidly as possible, so as to return control of investments and investment decisions to the customers, it is not possible to insulate customers from market risk, particularly where volatile market conditions, or volatile investments, are concerned.[35/] SIPA does have certain provisions which accelerate the claims process significantly. Thus, SIPC will make available to a trustee funds to satisfy customers, to the maximum limits of the $500,000/$100,000 protection available to each customer, even before it is possible for the trustee to amass and allocate assets between the fund of "customer property" and the general estate.[36/] A trustee also has the power to waive or modify the need to file a written statement of claim in order to sell or transfer the customer's account from the defunct broker to a financially sound SIPC member brokerage firm.[37/] This procedure can dramatically speed the process of satisfying claims, so that customers can exercise investment discretion with their portfolios as soon as possible.[38/]

Summary of the Options Available For Dealing With A Brokerage Failure

The following options are available for the protection of customers when a SIPC member brokerage firm is in or approaching financial difficulty.

1. The firm may be acquired, or merge with a financially sound brokerage, or liquidate, prior to the need for action by SIPC. This may be done with or without the assistance of a self-regulatory organization.

2. SIPC may initiate a liquidation proceeding. In smaller cases, SIPC may designate itself as trustee for the liquidation, to effect economy of administration.

3. In the case of very small brokers, SIPC may use the Direct Payment Procedure to satisfy customer claims without going through a full fledged liquidation.

4. In cases where (a) there is no exposure to customers who can be satisfied with advances from SIPC and (b) there is nonetheless a need for a judicially supervised liquidation, a brokerage may be liquidated under the auspices of subchapter III of Chapter 7 of the Bankruptcy code. If facts are subsequently discovered in such a case which render a SIPA proceeding appropriate, one may then be initiated.

SIPC Is Not A Regulator

SIPC was designed not to impose an additional layer of regulation upon the securities industry. Indeed, in 1970, prior to enacting SIPA, Congress considered a bill which would have created a Federal Broker Dealer Insurance Corporation as a government agency.[39] This approach was ultimately rejected in favor of creating SIPC as an entity which is not an agency or establishment of the United States Government.[40] SIPC has no power to supervise or examine SIPC members, or deal with matters of enforcement. These matters are left to the SEC and the self-regulatory organizations. In this respect, SIPC is markedly different from the FDIC and the FSLIC. The latter entities have an extensive supervisory and regulatory role; SIPC does not. SIPC's role is narrowly proscribed to the actual liquidation of a brokerage firm which is incapable of meeting its obligations to its customers.

SIPA was drafted to insure that SIPC works closely with the SEC and the self-regulatory organizations. The statute requires the SEC or any self-regulatory organization to notify SIPC "immediately" whenever facts are discovered which demonstrate that a broker or dealer is in or approaching financial difficulty.[41]

The Supreme Court has noted that a customer protection proceeding under SIPA is considered a "last resort."[42] SIPA specifically contemplates that, where feasible, a broker or dealer may liquidate or reduce its business with the assistance of a self-regulatory organization, and thereby obviate the need for a customer protection proceeding.[43]

III

Funding The SIPC Program

SIPA requires SIPC to establish a "SIPC Fund."[44] The SIPC Fund is financed by assessments levied upon SIPC member firms and interest on SIPC's investments. At present, the SIPC Fund contains $327,000,000. SIPA provides that in the event the SIPC Fund is or may reasonably appear to be insufficient for purposes of effectuating the program of customer protection, that SIPC may borrow up to one billion dollars from the United States.[45] SIPC has never made use of this borrowing authority. Further, SIPC has recently taken steps to assure that additional funds may be made available, if necessary, without resort to Federal monies.

In November 1985, a Special Task Force To Consider Questions Relating To The SIPC Fund And Assessments ("Special Task Force") submitted a report to SIPC's Board of Directors. As a result of that report, SIPC's Board has taken three actions.

First, the Board directed the SIPC staff to negotiate and present to the Board for its approval a $500,000,000 line of credit with a consortium of banks. Second, it determined that, effective April 1, 1986, the present one-fourth of one percent assessment on SIPC's members' gross revenues from the securities business would terminate. The Board of Directors specifically provided that this termination of assessments based on gross revenues is contingent on the $500,000,000 line of credit being effective on or before April 1, 1986.

Finally, the Board reviewed the SIPC Bylaws concerning the amount of assessments which would be levied upon SIPC's members in the future. An amended bylaw was approved by SIPC's Board and forwarded to the SEC in accordance with SIPA section 78ccc(e)(1). The bylaw will take effect if the SEC does not disapprove it pursuant to its authority under SIPA section 78ccc(e). The proposed bylaw amends section 1(a) of article 6 of SIPC's bylaws to read as follows: [46]

(a) Amount of Assessment

(1) If SIPC determines the balance of the SIPC fund as defined in section 4(a)(2) of the Act, exclusive of confirmed lines of credit, aggregates, or is reasonably likely to aggregate:

(A) less than $250,000,000 — the amount of each member's assessment shall be one-eighth of one percent per annum of such member's gross revenues from the securities business;

(B) less than $150,000,000 — the amount of each member's assessment shall be one-fourth of one percent per annum of such member's gross revenues from the securities business;

(C) less than $100,000,000 — the amount of each member's assessment shall be one-half of one percent per annum of such member's gross revenues from the securities business.

Such assessment shall commence on the first day of the month following the date on which SIPC announces its determination and continue until such time as SIPC provides otherwise.

(2) Notwithstanding paragraph (1) above, the minimum amount of each member's assessment shall be $100.00 for each calendar year or part thereof.

The Board of Directors also predicated the effectiveness of the proposed bylaw amendment upon the $500,000,000 line of credit being in place on or before April 1, 1986.

If the foregoing plan is placed into action, SIPC expects to have as of April 1, 1986 resources exceeding $830,000,000 which could be tapped before any need to draw on the statutory $1,000,000,000 line of credit with the Treasury Department. The proposed bylaw provides for the automatic imposition of assessments on gross revenues at the rate of one-eighth of one percent in the event the fund drops below $250,000,000 or in the event the Board determines the fund is "reasonably likely" to drop below that level. This and the other provisions of the proposed bylaw give SIPC considerable flexibility in maintaining the SIPC Fund at a level adequate to carry out SIPC's primary goal of enhancing and maintaining investor confidence in the securities markets. That flexibility also helps to assure that government funds will not be needed in the future.

It is the intent of the proposed bylaw that whether or not assessments based on a percentage of gross revenues are in effect during any particular calendar year, the minimum assessment paid by any SIPC member would be $100.00. While the statute allows for a minimum assessment as high as $150.00, the Board of Directors determined that $100.00 was appropriate at this time.

The Effect of Brokerage Failures on the SIPC Fund

The following table compares the number of SIPC members with the number of customer protection proceedings actually initiated over a five year period:

YEAR	Total Number of SIPC Members	Number of Customer Protection Proceedings Initiated By SIPC	Percentage of Total Membership
1981	7,176	10	0.13935
1982	8,082	8	0.09898
1983	9,260	7	0.07559
1984	10,338	9	0.08705
1985	11,000 (approximate)	12	0.10909

It is apparent that while SIPC membership has increased dramatically during the period in question, the number of firms requiring the initiation of a customer protection proceeding has not increased significantly. This can be attributed to a number of factors: the financial responsibility rules which require appropriate segregation of customer assets; the rules concerning the capital structure of brokers; increased internal controls by SIPC members; and improved surveillance by the self-regulatory organizations and the SEC.

In its fifteen years of existence, SIPC has initiated 189 customer protection proceedings. SIPC's net advances for these proceedings has been approximately $180,500,000. The two largest of those proceedings — Bell & Beckwith, of Toledo, Ohio, and Stix & Co., Inc., of St. Louis, Missouri, have required net advances from SIPC of $59,700,000. This represents 33% of the total advanced in all 189 proceedings over the fifteen year period. Fraud was the major factor in both of the two liquidations mentioned.

In its recent review of the SIPC Fund and the assessment structure of SIPC, the Special Task Force concluded that it is not appropriate to attempt to relate the size of the SIPC fund to the value of customer property being held by SIPC members. While the FDIC and FSLIC do relate the size of their respective funds to the size of their insured deposits, the nature of the securities industry differs in a crucial respect from the banking and savings and loan industries.

In the securities industry, customer property is protected by the financial responsibility rules and regulations, including particularly Rule 15c3-3 that "is well fashioned to furnish the protection for integrity of customer funds and securities as envisioned by Congress when it amended Section 15(c)(3) of the [Securities and Exchange] Act by adopting Section 7(d) of the Securities Investor Protection Act of 1970...."[47] Rule 15c3-3 requires broker-dealers to take possession of and maintain control of customer securities and restricts the use of customer funds to the financing of customer receivables or to deposit such funds in special reserve bank accounts for the protection of customers. This important rule is designed to protect customers who engage in securities transactions with a broker-dealer by ensuring that the broker-dealer maintains the customers' property in secure circumstances.

In addition, net capital requirements based upon liquidity have been in existence in the securities industry for decades. Recent years have seen a strengthening of standards in this area as well. The rules require broker-dealers to maintain minimum amounts of liquid assets in relation to their aggregate indebtedness and thereby attempt to alleviate the risks presented by potentially illiquid assets.

These requirements substantially differentiate the securities industry from the banking and savings and loan industries. The customer deposits in banks and savings and loan associations are available for management to lend or invest on a principal basis which frequently places the customer deposits in illiquid assets.

Projection of Future Expenditures By SIPC

Any projection of future needs must take into account the interest income which is earned on the government securities held for the SIPC Fund. For the past five years that income has been:

YEAR	INTEREST INCOME ON GOVERNMENT SECURITIES
1981	$24,001,865
1982	20,867,973
1983	18,147,989
1984	22,945,089
1985	31,000,000 (approximate)

Given the present size of the SIPC Fund, SIPC projects that the interest income on the SIPC Fund for 1986 will be approximately $31,000,000.

The Special Task Force concluded that the best indicator for determining SIPC's future needs was an analysis of SIPC's history of advances in prior proceedings. In the period from January 1, 1981 through June 1985, SIPC's net advances in 40 proceedings were $118,000,000. This is an average of $26,000,000 per year. This should be compared to our estimated interest income for 1986 of $31,000,000. With the SIPC Fund at its current level, $327,000,000, and the projected interest income, it would require the equivalent of seven years of advances (using the $26,000,000 average) in a very short period of time, to reduce the SIPC Fund below the $150,000,000 level. It is at the latter level that SIPA requires SIPC to base its assessments on the gross revenues of its members.

IV

CONCLUSION

SIPC constantly seeks to improve its performance, particularly in the area of satisfying customer claims in a timely fashion. In 1985, SIPC began the installation of computers to assist in its functions. SIPC hopes to realize significant savings of both time and administrative costs as more aspects of the SIPC program are computerized. In addition to using the computers in connection with customer

STUDY ON RISK-RELATED PREMIUMS

The CHAIRMAN. Thank you very much.

Dr. Utgoff, you mentioned the study on risk-related premiums. We have been discussing that in our hearings on FSLIC and FDIC. There's a lot of opposition to it, but certainly the issue of fairness speaks in favor of going that direction, because that some banks and some S&L's simply aren't as well run as some others. They have assets in more risky ventures than others and certainly representatives of the insurance business know about assessing risks. They do place different values on risk, whether it's automobiles or fire insurance.

Would it be possible for you, when that study is completed, to supply the committee with a copy of the study that is being done on risk-related premiums?

Dr. UTGOFF. I'd be happy to.

The CHAIRMAN. We would appreciate that. I think it would be helpful in our deliberations on reforming deposit insurance for FSLIC and the FDIC.

During our hearings, as far as the FSLIC and FDIC is concerned, there's been virtually no discussion of privatization. I understand that there have been some proposals to allow private concerns to underwrite pension insurance. Do you have any comments on those proposals?

Dr. UTGOFF. There have been no such proposals. PBGC has a seven-member private sector advisory committee that set up a task force to look at the idea of privatization. So far we have no proposals and no operational plans for privatization. We have been looking at how a private company would offer the same services that we do, so that we can perhaps improve our procedures.

The CHAIRMAN. As I'm sure you're well aware, both the FDIC and the FSLIC, they have regulatory authority.

Dr. UTGOFF. Yes.

The CHAIRMAN. And apparently you do not. What type of supervisory authority do you have over those funds that you insure?

Dr. UTGOFF. We have very little authority. Regulatory control of plan funding—and other supervisory authority are really held by other agencies. We have one action that we are able to take, which is an involuntary termination of the plan when it looks like it's going to be a severe risk to the PBGC. However, for reasons that I'm sure you can imagine, it is an action that's rarely undertaken and usually would be undertaken only to make sure that participants stay in pay status. In other words, when the plan has been abandoned and there's just not enough money in the plan. If we were to terminate a plan that was simply getting into more trouble, literally PBGC going in and taking over the plan and a third of the net worth of the company that maintains the plan, we could jeopardize the business.

So really the only regulatory tool that we have is this involuntary termination that is rarely used and, I believe, should be rarely used.

The CHAIRMAN. Mr. Muhl or Mr. Washburn, for the most part State guaranty funds operate on a postassessment basis. Operating in that manner as opposed to the other insurance funds we've talked about, where do you get your operating capital when the funds are collected after the fact?

Mr. WASHBURN. The guaranty fund in the property and casualty industry was never thought to be an ongoing operation. It was thought to be able to payoff claims and cease to exist or at least lie dormant until the next insolvency came in. In many cases, that has not been the case. There have been many States that have had insolvencies long enough that the operation is ongoing. They have a special assessment that they have for operating funds, just for operating the guaranty fund itself.

In the life and health, they are still coming to grips with the fact of how do you continue coverage—in other words, do you sell the business to another life insurer, do you have to keep it yourself, depending on the types of business? They also have an administrative account.

The way claims are paid when they first appear is the commissioner will trigger the guaranty fund and it will start to get the claim files, both in the life and health and the property and casualty area. They usually have funds left over from prior insolvencies that have either not been sent back to the companies or some sort of funding mechanism that can take care of the claims when they first come in, and usually they are able to get their assessment out within 30 or 60 days.

So there is usually a continuation on the stream of claims payments that happen in this postassessment mechanism.

The CHAIRMAN. The committee has heard a number of times, not only in hearings but in correspondence, that some banks and savings and loans are simply too big to be allowed to fail. A few years ago we had some serious problems with Geico that I'm sure you're very familiar with.

TOO BIG TO FAIL MENTALITY

Is there that same kind of mentality in the insurance industry, that some companies are just too big to be allowed to fail?

Mr. WASHBURN. I don't know whether the mentality is there that they could not be allowed to fail. I know it would cause a major problem if the larger insurers in the world, State Farm as an example, were to run into difficulties.

The early access provisions of the guaranty fund stage which allow—basically what happens is the regulator who is usually the receiver or the liquidator estimates what it will cost him for running the liquidation procedure and then is able to turn the majority of the funds over to the guaranty fund to help them with payments. It gives you a great deal more capacity because even if an insurer goes insolvent, although its reserves are probably deficient, they at least do have some reserves there.

We have been trying to sit down to determine what happens in terms of capacity to take care of a series of insolvencies or one jumbo insolvency. There is a question as to how great a capacity you actually need out there.

But I don't think anyone has ever expressed the thought that you cannot let one go insolvent. I think it's very difficult if a large one goes insolvent, depending on the line of insurance. It would be extremely difficult if it were a large workers compensation insurer, as an example, goes insolvent because now there will be no cap on those payments, but we have never been faced—I think Geico is about as close as we came and they worked to try and work that one out simply because they were worried about what was going to happen, about the assessment mechanisms, as to what would happen to the rest of the industry when the assessments went through.

The CHAIRMAN. Mr. Focht, my understanding of SIPC is that customer assets are frozen in any liquidation proceeding. Is that correct?

Mr. FOCHT. Pending the processing of the customer claims, that's correct, basically.

The CHAIRMAN. Do you need more flexibility in dealing with failed broker-dealers in that situation?

Mr. FOCHT. I don't think so, Mr. Chairman. In 1978 we received from the Congress amendments which have made a big difference in the time period during which customers do not have access to their accounts. I'm thinking particularly of the ability which Congress provided in 1978 to do a bulk transfer of customer accounts to another broker-dealer.

We have now had a fair amount of experience with that provision, and we believe that that has improved this problem considerably.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman. I will be brief.

POSSIBLE SOLUTIONS FOR FSLIC PROBLEMS

I just have two questions, one for Mr. Muhl and Mr. Washburn. Presumably, one of the purposes of these hearings is to gain an insight into what we do about FSLIC. As you know, FSLIC is in very serious trouble. It has $14 or $15 billion in potential losses and only about $4 billion in the till. We have four options for dealing with this and I'd like you to tell me which option you think is the best.

One, increase the premiums charged healthy S&L's; two, merge FSLIC with the FDIC and use the latter's funds to cover the losses; three, provide for a bailout by the U.S. Treasury; and four, do nothing and hope we can muddle through.

Up to now we've followed that fourth policy. Based on your experience, which of the four policies do you think we should follow?

Mr. WASHBURN. Well, it's truly very difficult not knowing exactly how they're set, but I would suppose the increased premiums on the others. I'm not quite sure—it's one of the things we're looking at in terms of how much we ought to be able to assess the insurance company as well as the impact of assessments on the vitality of the rest of the members.

Senator PROXMIRE. Do you think that's practical and would be effective and would provide enough so that we could get through this situation which seems so serious? After all, we've been in a growth period for the past 3 or 4 years and I dread to think what will happen if a recession hits, which could happen. After all, nobody has repealed the business cycle.

Mr. **Washburn**. Well, again, I have, to be quite frank, such little knowledge on exactly what that would do to the rest of the industry, I hesitate in some sense to answer; but it is the type of thing as an example we would probably look at in Illinois if we were to run into a problem is whether we would increase the cap on the amount that we could assess the remaining industry. That would probably be one of the first things that we would address.

Senator **Proxmire**. Do you want to follow up on that, Mr. Muhl?

Mr. **Muhl**. I was going to suggest to you that I would agree with Director Washburn that probably increasing the premium would be the direction that we would look at. Again, we are not that knowledgeable reference the FSLIC and so forth.

The major concern that we would have, though, on any increased premiums on the assessment process would be that impact that it would have on the remaining solvent carriers or banking facilities or what have you. You have to make that determination as to the ultimate impact and if you make that determination that they can in fact be assessed or receive an increased premium and still not be in financial jeopardy where solvency would be an issue, then that would be one way to consider it, but you would have to make that determination, in our opinion, as to the impact it's going to have on the remaining carriers.

Senator **Proxmire**. Dr. Utgoff, you look as if you have a burning desire to answer that question.

Dr. **Utgoff**. I didn't know I looked that way.

Senator **Proxmire**. You look great.

Dr. **Utgoff**. I've worked with a number of insurance programs. I've studied unemployment compensation and workmen's compensation, and I think the discussion of Baldwin United points out one of the problems with a flat-rate premium. I think that, rather than raising the premium on healthy members, everyone ought to look at the benefits, not just in terms of fairness, but in terms of what it does to the incentives of the system. If you want to engage in investments or operations that are more risky and have a higher rate of return, you should pay a higher premium to the insurance system that covers failures for that system.

The problems that we have discussed today and the ones that you are addressing are often characterized by just that. People can take additional risks that on average offer a higher rate of return, yet the insurance system that's backing them up does not ask them to pay the cost of that additional risk. So I would suggest that another alternative be added to your list—a risk-rated premium.

Senator **Proxmire**. Well, let me ask Mr. Focht about that particular thing. Mr. Focht, it's been suggested that the FDIC and FSLIC vary their premiums, as Dr. Utgoff has proposed, in accordance with some measure of risk forged by the bank or thrift institution.

To what extent has the idea of risk-based insurance been a part of your experience and what observations do you have concerning its relevance for FDIC and FSLIC?

Mr. **Focht**. Risk-rated premiums or assessments have not been part of my experience in that we have not had them at SIPC. Our assessments, when they have been imposed, have always been on the statutory base of gross revenues from the securities business.

What thoughts do I have on risk-related premiums for the FDIC and FSLIC? I think I would just have to say, Senator Proxmire, that I do not have the knowledge of those industries that would be needed to make a definitive response to your question.

Senator **Proxmire**. Well, you're the insurance experts. I appreciate that answer and I think I understand it, but I wonder if you could give us some advice on this kind of thing. Usually risk-related premiums are viewed by many as something that the private insurance industry has a great deal of experience with and applies, and one of the criticisms of Government is that we don't do it for political reasons. We get pressured, people saying you're discriminating against us, and that's one of the reason for some people arguing for privatization in many areas. So can you help us a little bit more on that? Can anybody on the panel suggest what the efficacy is of risk-based premiums?

Mr. **Washburn**. We've talked about it somewhat whenever you get into the discussion of prefinancing. There is the question of whether you ought to charge some companies more in terms of the risk of the type of venture that they're in, and the problem of course is flexibility. What may be risky this year may turn out in the end because of the marketplace function to be very safe in a couple of years, and I know in the insurance industry the nature of the insolvent insurers has changed. We notice that for several reasons because of changes in the marketplace both in the product mix and in the way they do the business. So you have to retain some flexibility to change that on a yearly basis, the same way I think that the insurance industry actually does it.

But on a preassessment mechanism, in some cases, it would probably make sense to determine the type of marketplace they were in and determine your premiums off of that.

Senator **Proxmire**. Thank you.

Thank you, Mr. Chairman. Mr. Chairman, I have another question I won't ask now but for the record could it be submitted to the witnesses for their response for the record?

The **Chairman**. Certainly, and after we've finished our oral questions, I would expect that there would be some questions for your response in writing from some of the members of the committee who were not able to be here this morning.

Senator Gorton.

Senator **Gorton**. Thank you very much, Mr. Chairman. I do not have any questions at this time.

The **Chairman**. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

I have a question for Mr. Muhl and Mr. Washburn. Gentlemen, it's no secret that the property and liability insurers have been hard hit lately in that small business and others are reeling under the strains of massive premium increases. I'm hearing constantly from small business people in my State about this problem.

INCREASE OF INSURER INSOLVENCIES

The Wall Street Journal yesterday provided an overview of the breadth of the current affordability and availability crisis plaguing both insurers and the small businesses that they insure.

Do either one of you gentlemen believe that insurer insolvencies will increase this year? Do you want to respond to that, Mr. Washburn?

Mr. WASHBURN. The number of companies that are on our watch list on quarterly returns and so forth have increased 33 percent in the last year. So in that sense——

Senator DODD. That's in Illinois?

Mr. WASHBURN. Those are the companies that operate in Illinois, that's correct. There are about 750 property and casualty companies operating in Illinois and we had an increase of about 33 percent of the number of companies that are on our watch list from last year to this year. So in that sense, we see a weaker industry out there, yes.

Mr. MUHL. The watch list, Senator, that he is referring to is the National Association of Insurance Commissioners has produced a system referred to as IRIS. It's the insurance regulatory information system. And all the financial data of each company licensed in any of the jurisdictions of the United States is put into this data base of the NAIC and there are 14 tests that are run to determine the financial stability and solvency of these companies.

There have been at least a 33-percent increase in the number of companies that have triggered or failed some of these tests that are going on to the NAIC watch list for regulatory review.

Senator SASSER. Well, gentlemen, I suppose my next question would be: Will the property and liability guaranty fund be able to handle what appear to be increased risks of companies failing? In other words, what's your estimate on failures and whether the fund will be able to handle these failures?

Mr. WASHBURN. Indeed, that is one of the ongoing discussions we've been having both among the regulators and with the industry is what is a likely scenario and how much can they handle and how much ought they be able to handle.

One of the things you've got to remember with an insurance company is, unlike a bank, not everyone runs for their money at one time. The claims come in over a timely basis. Some of the claims take several years to adjudicate to get to a point where they have to be paid.

So in some sense, the type of business determines when the guaranty fund is going to be hit by the claim. It may be several years. The guaranty fund usually stays open for a certain amount of time to receive claims. So it is not always a sense of going out to try and get the money.

One of the things we are trying to key in is, what is the usual payout claim when there is an insolvency because it is a different payout scenario than you have for a company. Indeed, we are trying to work on that to determine whether we have a system that has the capacity to take care of all the problems that may indeed occur. We have had—last year I think there were 20 insurance companies that went insolvent. So far this year we have had 16.

Senator SASSER. This is in Illinois?

Mr. WASHBURN. No, this is nationally. We are trying to develop what will happen if we have something go down. We think right now that the system may be over capacity, with early access, the ability to borrow, and the fact that the claims structure is such that it does not all come in at once. But we realize that over the next several years there are some problems out there that we are going to have to address and it is one of the things that we are looking at to try to understand whether we do have the capacity to take care of what we see coming.

Senator SASSER. Well, gentlemen, I've conducted some hearings in my State on the problem of insurance and I learn there's a great divergence among State insurance commissioners about how to deal with the crisis. Some State commissioners are saying that small businesses should just wait for the market to correct the situation. That's the position the insurance commissioner takes in my State. It's not a very popular position with a lot of those who are seeking insurance coverage. Other States are taking a more active role in seeking relief for small businesses hard hit by the escalating premiums and also by a lack of coverage.

Now this diversity is adding to the uncertainty that many firms are facing, particularly those that might operate across State lines.

Is the National Association of Insurance Commissioners working on a uniform policy on how best to handle these problems? What course of action would either of you recommend or both of you?

Mr. MUHL. In response to that, Senator, the National Association of Insurance Commissioners as well as the individual State regulators have been very concerned with what's been happening to the insurance consumer or the individuals in our respective States. We have in most States, if not all States, formed a voluntary mechanism referred to as a market assistance program in an attempt to create markets that do not presently exist for certain lines of insurance. And I suggest to you that this is a voluntary effort. This is asking the insurance industry to voluntarily create these markets to supply the insurance in certain areas.

The NAIC as a whole has formed recently a clearinghouse concept where we're getting communications from the various trade associations involved in the insurance business and, in turn, from the various companies to locate, if you will, the capacity that's there in the industry, where this capacity is, and match the buyer and the seller of insurance together.

This information is also being disseminated to the various State insurance departments as an assist to their market assistance program efforts. I know it's worked well in my State. We have created three market assisted programs. Illinois I know has done this and many of the other States have created similar programs.

There are, though, Senator, certain coverages that may not be insurable. One of the major concerns of the industry is that if they can price a risk they will probably be in a position of selling the insurance. But there are a lot of risks where they can't calculate how much it's going to cost.

AFFORDABILITY OF INSURANCE

Senator SASSER. What about affordability? That's one of the principal complaints I get, that, sure, you might be able to get the coverage but you can't afford it. The premium has gone up 500 per-protection proceedings, administrative efficiencies should be realized in other areas, such as membership and assessment records, internal accounting, and legal data storage.

Continued emphasis on effective self-regulation of the securities industry and early identification of brokers which may be approaching financial difficulty are essential to the SIPC program. SIPC believes that the relatively small number of customer protection proceedings initiated over the last five years is an indication that this approach is working to identify problem brokers *before* liquidation is necessary. When it is necessary to initiate a customer protection proceeding, SIPC has the experience and resources needed to deal with the matter. We believe the record demonstrates that SIPC, since its inception, has responded efficiently and effectively to the mission it was given by Congress. We are confident we will be able to continue to do so in the future.

Footnotes

1/ 15 U.S.C. section 78aaa *et seq.* (1981). Future reference to sections of SIPA will omit reference to 15 U.S.C. SIPA was amended by Pub. L. No. 95-283, 92 Stat. 249 (1978), Pub. L. No. 95-598, 92 Stat. 2549 (1978), Pub. L. No. 96-433, 94 Stat. 1855 (1980), and Pub. L. No. 97-303, 96 Stat. 1410 (1982).

2/ *See, e.g.*, *Duel v. Hollins*, 241 U.S. 523 (1916), *Gorman v. Littlefield*, 229 U.S. 19 (1913); *Sexton v. American Trust Co.*, 45 F.2d 372 (8th Cir. 1930); *see also*, *In re McMillan, Rapp & Co.*, 123 F.2d 428, 431 (3d Cir. 1941); *Leonard v. Hunt*, 36 F.2d 73 (2st Cir. 1929); *In re Byrne*, 32 F.2d 189 (2d Cir. 1929); *Duncan v. Johnston & Co.*, 3 F.2d 422 (6th Cir. 1925); *In re Codman, Fletcher & Co.*, 287 F. 806 (1st Cir. 1923); *In re Toole*, 274 F. 337 (2d Cir. 1921); *In re B. Solomon & Co.*, 268 F. 108 (2d Cir. 1920); *In re McIntyre (Appeal of Hudson)*, 181 F. 955 (2d Cir. 1910); *In re Kennedy & Greenwood, Inc.*, 23 F.2d 601 (D. Maine, 1928); *In re James Mac Farlane & Co.*, 14 F.2d 876 (W.D.Wash. 1927); *In re Archer Harvey & Co.*, 289 F. 267 (D. Md. 1923); *In re J. C. Wilson & Co.*, 252 F. 631 (S.D.N.Y. 1917).

3/ 11 U.S.C. §96e.

4/ S.R. No. 91-1218, 91st Cong., 2d Sess. 4 (1970) ("Senate Report". *See also*, H.R. No. 91-1613, 91st Cong., 2d Sess. 1 (1970) ("House Report"); *SIPC v. Barbour*, 421 U.S. 412, (1975).

5/ SIPA section 78ccc. There have been some challenges by broker-dealers as to SIPC membership. *See Massachusetts Financial Services, Inc. v. SIPC*, 545 F.2d 754 (1st Cir. 1976), *cert. denied* 431 U.S. 904 (1977); *SIPC v. Georgeson & Co.*, 1979-1980 Transfer Binder, CCH Fed.Sec.L.Rep. ¶97,246.

6/ SIPA section 78ddd.

7/ SIPA section 78ddd(f), (g), and (h).

8/ SIPA section 78fff(a).

9/ SIPA section 78fff-1(a).

10/ *In re Lewellyn*, 26 B.R. 246, 253 (Bkrtcy. S.D. Iowa 1982); *Gold v. Hyman*, CCH Fed. Sec. L. Rep. ¶95,043 (S.D.N... April 1, 1975).

11/ SIPA section 78eee(a)(3).

12/ *SIPC v. Barbour*, 421 U.S. 412 (1975). In the event SIPC refuses to commit its funds or otherwise act for the protection of customers of any member of SIPC, the Commission may apply to the District Court in which the principal office of SIPC is located to compel SIPC to discharge its obligations. SIPA section 78ggg(b). To date, the Commission has never initiated such an action.

13/ SIPA section 78eee(b)(3). SIPC's discretion in this matter is thus the critical factor. The court is not free to ignore the specifications made by SIPC. *See Securities and Exchange Commission v. Oxford Securities Ltd.*, 354 F.Supp. 381 (S.D.N.Y. 1973), *reversed w/o opinion*, 486 F.2d 1396 (2d Cir. 1973). The *Oxford*

Securities case was decided prior to the 1978 Amendments to SIPA. Congress endorsed SIPC's authority with respect to specifying the trustee and counsel, by amending the statute in 1978 to provide that SIPC was to have "sole discretion" in this matter. *See In re First State Securities Corp.*, 39 B.R. 26 (Bkrtcy. S.D. Fla. 1984). Although SIPC does designate the trustee and counsel for the defunct firm, those fiduciaries are independent of SIPC. By way of example, trustees specified by SIPC have on occasion taken positions opposed to SIPC's position in litigation. See *SIPC v. Morgan, Kennedy & Co., Inc.*, 533 F.2d 1319 (2d Cir. 1976); *SEC v. Wick*, 360 F.Supp. 312 (N.D. Ill. 1973). Should SIPC determine that the member's liabilities to unsecured general creditors and to subordinated lenders aggregate less than $750,000 and that the member has fewer than 500 customers, SIPC may specify itself, or one of SIPC's employees, as trustee.

14/ SIPA section 78eee(b)(4). *Exchange National Bank v. Wyatt*, 517 F.2d 453 (2d Cir. 1974).

15/ *See* Senate Report at 11, House Report at 10, *SEC v. F. O. Baroff Co., Inc.*, 497 F.2d 280 (2d Cir. 1974); *SEC v. Aberdeen Securities Co., Inc.*, 480 F.2d 1121 (3d Cir.), *cert. denied*, 414 U.S. 1111 (1973); *SEC v. Kenneth Bove & Co., Inc.*, 378 F. Supp. 697 (S.D.N.Y. 1974); *SEC v. Albert & Maguire Securities Co., Inc.*, 378 F.Supp. 906, 911 (E.D. Pa. 1974).

16/ *SEC v. Aberdeen Securities Co., Inc.*, 480 F.2d 1121, 1123, *cert. denied* 414 U.S. 1111 (1973).

17/ *SIPC v. Associated Underwriters, Inc.*, 423 F.Supp. 168, 173 (D. Utah 1975).

18/ SIPA section 78lll(4).

19/ SIPA section 78lll(11).

20/ SIPA section 78fff-3(a).

21/ SIPA section 78fff-3(a).

22/ Senate Report No. 95-763, 95th Cong. 2d Sess. (1978) at 1.

23/ SIPA section 78lll(4).

24/ SIPA section 78lll(3).

25/ Hearings before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate, 95th Cong. 2d Sess. on H.R. 8331 (1978), at 41-42.

26/ A complaint in reclamation is generally unnecessary, however. Under the procedures adopted in most SIPA liquidations, see *SIPC v. Saxon Securities Corp.*, CCH '75-76 Transfer Binder Fed. Sec. L. Rep. ¶95,397 (bkrtcy. S.D.N.Y. June 24, 1975 as supplemented December 18, 1975), distributions are made to all customers once their claims have been reconciled with the debtor's books and records. The owner of customer name securities, who may not know in any event whether the broker did register the securities in customer name, need only file a claim with the trustee. Further, because customer name securities are the property of their registered owner and do not become part of the fund of customer property, the usual time limits for filing claims which are discussed *infra* may not apply.

27/ SIPA section 78fff-4(a).

28/ SIPC is here to be distinguished from those cases in which SIPC is acting as trustee for the member in a liquidation proceeding.

29/ SIPA sections 78fff-4(b) and (c).

30/ SIPA section 78fff-4(e).

31/ Hearings before the Subcommittee on Consumer Protection and Finance of the Committee on Interstate and Foreign Commerce. 95th Cong. 1st Sess. on H.R. 8331 Serial No. 95-77 at 111, 130-132 (August 1, 2 and 3, 1977).

32/ SIPA sections 78fff-1(b)(1) and 78fff-2(d).

33/ A brokerage firm that, for any reason, is being liquidated under the Bankruptcy Code, as distinct from SIPA, *must* reduce all securities positions to cash. 11 U.S.C. section 748. It is theoretically possible for a brokerage firm to be insolvent, and to have liabilities to customers, under circumstances where none of the customers are entitled to SIPA protections. SIPC would not initiate a liquidation proceeding in such a case. *See* SIPA section 78eee(a)(3). In such a bankruptcy subchapter III of chapter 7 of title 11 provides the procedural framework for the liquidation of the stockbroker. See 11 U.S.C. sections 741-752. Those sections are specifically *not* applicable in a SIPA proceeding. SIPA section 78fff(b).

34/ SIPA section 78fff-2(c).

35/ Speed of distribution is a problem in brokerage bankruptcy because of the sometimes volatile nature of a customer's investments. It is not possible to liquidate a brokerage firm and satisfy its customers with the same dispatch as the Federal Deposit Insurance Corporation ("FDIC") or the Federal Savings and Loan Insurance Corporation ("FSLIC") can satisfy the depositors of a bank or savings and loan association. The matrix of possible relationships between a customer and his broker are more numerous and more complex than the possible relationships between a depositor and his bank. In 1982, the Report of the Special Task Force to Consider More Flexible Procedures For Liquidations Under The Securities Investor Protection Act of 1970 stated some reasons for this:

> Customers of banks and savings and loans have insured cash balances which can easily be paid out or transferred by the FDIC and the FSLIC almost immediately after a liquidation proceeding is initiated. Securities brokers, on the other hand, in addition to cash balances, hold customer accounts in the form of many different securities which must go through a time-consuming transfer process before delivery to individual customers. While bulk transfer to other brokers using electronic book-entry transfer through securities depositaries immensely simplifies this process, transfers still cannot be carried out nearly as quickly as in the banking and savings and loan industries. There are several reasons for this:

(a) Five business days of securities transactions are always in the process of settling;

(b) A bulk transfer requires advance preparation in the form of necessary computer programming and processing;

(c) Receiving brokers must review transferred accounts to determine whether the accounts meet their credit or other standards, and may refuse to accept some accounts or securities; and

(d) Numerous transfer agents, and banks to which customers' securities have been pledged, must review the trustee's legal authority to act. In addition, the trustee might have to negotiate various agreements with the pledgee banks.

Another obvious difference is that keeping track of customers' transactions in securities, possibly including, among other things, both long and short securities positions, options, dividends, and margin debits, and pending transactions is a vastly more complicated process than keeping track of deposits and withdrawals at a bank or a savings and loan association. As a result, when a trustee takes over a stock brokerage firm, he often finds customer records which are in disarray — something which appears to happen rarely in a bank or savings and loan proceedings. Unreliable customer records will further delay, or perhaps prevent entirely, a bulk transfer of customer accounts. In the meantime, securities customers who do not have access to their accounts are subject to market risk — something which bank and savings and loan customers do not have to worry about.

36/ SIPA section 78fff-2(b)(1). The trustee and SIPC then make accounting adjustments once the actual size of the fund of customer property and each customer's ratable share is determined. The size of the fund of customer property need only concern customers who are ineligible for advances by SIPC, or whose claims exceed the limits of protection. A protected customer who has a claim for securities or cash which is within the limits of protection may be satisfied from funds advanced by SIPC, even in a case where there is *no* customer property located. Since a customer's ratable share of customer property is a function of both the amount of customer property actually recovered and the amount of valid claims against such property, the earliest that a trustee can determine the ratable share is after the expiration of the six-months time period for filing claims in the proceeding.

37/ SIPA section 78fff-2(f). It is not always possible to transfer accounts in such a fashion. In particular, where a debtor's books and records are in disarray, an account transfer is virtually impossible. Also, a debtor firm may have had the least stringent margin requirements permitted by regulation; a potential transferee brokerage firm may have margin requirements stricter than those actually required. This would impede such a transfer of accounts.

38/ Portfolios with very volatile securities are particularly vulnerable to delay in satisfaction of customer claims. Particularly, securities issues where a debtor firm was a principal underwriter or market maker may be severely affected by the broker's failure. The same is true for securities of corporations caught up in a tender offer.

39/ *See* S.2348, 91st Cong. 1st Sess. (1969) and Hearings Before the Subcommittee on Securities of the Committee on Banking and Currency, 91st Cong., 2d Sess., on S.2348, S.3988, and S.3989 (1970).

40/ SIPA section 78ccc(a)(1)(A).

41/ SIPA section 78eee(a)(1).

42/ *SIPC v. Barbour*, 421 U.S. 412, 421 (1975).

43/ SIPA section 78eee(a)(2).

44/ SIPA section 78ddd(a)(1).

45/ SIPA section 78ddd(f), (g), and (h).

46/ Section 1(a) of article 6 now reads as follows:

(a) *Amount of Assessment.*

(1) At any time that SIPC determines that the balance of the SIPC fund (exclusive of confirmed lines of credit) as defined in Section 4(a)(2) of the Act shall aggregate less than $150,000,000 (or such other amount as the Commission has determined pursuant to the Act), the amount of each member's assessment shall be one-fourth of one percent of such member's gross revenues from the securities business (with a minimum assessment of $25.00 for each calendar year or part thereof) commencing on the first day of the month following the date on which SIPC announces its determination that the SIPC fund has reached such level and continuing until such time as the Board provides otherwise.

(2) During any calendar year when the assessment rate set forth in (a)(1) above has not been in effect, the amount of each member's assessment shall be $25.00 for each calendar year or part thereof.

47/ Securities and Exchange Act of 1934, Release No. 9856.

cent or more since last year and there's been no loss experienced on the part of the business being insured.

Mr. MUHL. And in a lot of cases that is the case. We've had complaints come to each of us individually indicating that they have no claims and why is their insurance going up? Well, the whole concept of insurance is, if you will, the concept of the law of large numbers. You are going to have certain individuals that have claims and others that do not, and you're going to spread that risk over a certain category of these individuals and you're going to have good insureds, if you will, picking up the tab for the bad ones or the poor risks. You're spreading that risk, so you have the good numbers compensating for the poor numbers. That is the concept of insurance.

So there are going to be some individuals in a particular category who have had no claims and yet their insurance will rise because they are in a classification or a category with others who have had claims. That's going to happen. Again, that's the system. That's the way the system works and it's designed to work.

Now as to affordability, we are very concerned about that as well. I'm not sure if we have all the answers or any of the answers at this point concerning the affordability. But if you look back in time as to what has occurred over the past several years, we had some unusual factors that have affected the insurance business. Some of those factors were controlled factors and some uncontrolled factors. Some of the uncontrolled factors are that we have a world economy that has gone just a little crazy. We had a 21-percent prime interest rate here in the United States. We had a situation where these companies were able to take some premium dollars in and not charge all that they should have charged to compensate for that risk.

Senator SASSER. They would have been cutting premiums just to get the dollar in there?

Mr. MUHL. Absolutely. And, in turn, they were able to make up the difference in short-term investment return. As a result, there was a lot of ill-priced business on the books and premiums that were really low and when the bottom in interest rates fell out—and it did so abruptly, unfortunately—there was a lot of this ill-priced business on the books and companies are then starting to have solvency concerns and that's when the prices started to rise.

But a lot of those charges that are being made now are proper charges because it compensates for that which is being paid out in the form of lost dollars. It's high. In some cases, it's unaffordable, but it's a reasonable rate that's being charged for the product that's being sold.

Senator SASSER. I'm not sure that most of the insureds or those who seek insurance would agree with you on that, at least the ones I've talked to.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

Just on that last point Senator Sasser has raised, Senator Gorton who is sitting with us here, and Senator Danforth and I and others have been working over the last year on trying to come up with an ideal workable solution to the product liability issue. I just wonder if the two commissioners—how they would rate that particular problem as it has affected the affordability question. The better question is the price and pricing insurance in the explosion in the product liability area.

Mr. WASHBURN. If I could start, there is a great deal of concern among the insurers as to whether they can adequately price product liability insurance because of the changing nature of the system and the fact that we may write a policy this year thinking this is what the payment structure is going to be in the future and it may change radically on you in terms of the types of claims that can be brought and the size of those claims when they are finally adjudicated, and it's made the insurance industry very nervous about that whole line of business.

And they like to operate on some sort of stability. They don't see a stability in the tort structure there and it may be inherent with the type of structure that is out there. I mean, there may just not be a chance for flexibility in that structure.

CYCLICAL SWINGS IN INSURANCE

What I think is going to happen is the industry is going to react as it has in the past. Capital will flow in when they think they are able to make money on the line. They will sell the business. If they start to lose on it it will tighten up a great deal and we will have these cycles, these swings and cycles, and they may get more extreme as this goes on. But it's going to be a cyclical business until they feel——

Senator DODD. It has been anyway. Insurance has been cyclical. It has its peaks and valleys.

Mr. WASHBURN. The swings seem to be getting worse. One of the problems in this marketplace is you have great numbers of companies selling the business and no one has a very large share of the marketplace. I think the largest company has about 6 percent and it's very difficult when you don't have a price leader. Also you have an industry that until the 1940's had had what was called the cartel. They had set the prices. They were able to pass around bad business through this cartel mechanism and they made sure everybody was able to make money.

With the Supreme Court case that destroyed the cartel, they set up a system of rating in the State system and more or less kept the theory of the cartel alive, although not the actual essence. Gradually, that has just decayed on them and, as a matter of fact, for the last several years, although the insurance industry had groups that came out and told them what the rate ought to be, the rates that either the States approved, if States had approved their rates, or the rates that were published by their own rating bureaus were just disregarded. They paid no attention. It was really the end of the cartel and they desperately searched for someone to be a price leader. One company tried in 1981 I think, Aetna, and wound up losing a lot of business and so it scared the rest of them. And what's happening is now that the marketplace is tightened up, they all thought they were losing money and they all have really been sort of wondering when this was going to happen and the reaction has been extreme.

Senator DODD. We're getting astray from the issue but I might suggest, Mr. Chairman, this is—yesterday I spoke to a group of people, about 300 of the top independent agents across the country that were in Connecticut, I might add, at a conference there, and this was the dominant discussion. I think the subject matter—I don't know what our hearing schedules are like and I'm kind of digressing here to this subject, but I really think it's one we ought to explore. I think it's a proper subject matter for this committee.

The CHAIRMAN. I would say that I have a solution, as I mentioned to Attorney General Gorton here, that we just outlaw attorneys, that would——

Senator DODD. I would not put that on a national referendum.

The CHAIRMAN. That would solve a lot of the problem we're talking about.

Senator DODD. I must say I was intrigued, as you must appreciate, when you talked about a bill that was introduced by my father back in the late 1960's I guess. I suppose children ought to know about what their fathers were doing. What was in that bill and how does it differ from what you have established in 47 States?

Mr. WASHBURN. It was a Federal guaranty fund for insurance and it was basically addressing the same issues. In those days the problem really was small automobile insurance companies were going insolvent, a great number of them, and they wished to address this problem of the policyholder who was left truly holding the bag when these companies went insolvent.

STATES PASSED GUARANTY FUND STATUTES

In response to that, the majority of States within a period of 1 or 2 years passed their own guaranty fund statutes in each State that really closely resembled what was trying to be accomplished nationally.

Senator DODD. Was that 47 States that have done that?

Mr. MUHL. Yes.

Mr. WASHBURN. All the States have a fund of some sort.

Senator DODD. What about life and health? You didn't mention the number of States that have that.

Mr. MUHL. There are 38 States.

Senator DODD. So, 38 have the life and health guaranty funds.

Mr. WASHBURN. Yes; 47 States needed to pass it because the others already had one at that time. There were three States that had a fund and some mechanism to take care of that problem prior to 1969. In 1969 the rest of the States all passed it, I think, within 1 or 2 years and clearly your father's bill was a major impetus for getting this through so quickly in all the general assemblies.

Senator DODD. Tell me about the—you know there's great disparity—and obviously I'm not asking you to identify States and compare them, but the NAIC—have you made any recommendations as to minimum standards in terms of commissioners' offices and so forth, the regulatory scheme in various States and so forth, that would provide the kind of at least regulatory insurance, if you will, against companies reaching the point where they do end up failing so that you minimize at least the possibility of these funds being tapped?

What recommendations has NAIC made in that regard, if any?

Mr. MUHL. The NAIC has not made recommendations per se to set minimum standards, if you will, of State insurance department functions or operations. One of the purposes and reasons behind the NAIC is to supply that degree of uniformity for insurance matters that do transcend jurisdictional boundaries.

One example, there is near 100 percent uniformity with reference to financial aspects of regulation of insurance carriers. All the information, for example, that's supplied is supplied on a uniform basis by all insurance companies to the various insurance departments, from the companies to the insurance departments and then, in turn, to the NAIC on the data collection and financial status on each of the companies. That's a uniform reporting system that was adopted by all the States that was created through the NAIC. So in areas such as the financial aspect and in a lot of cases the guaranty mechanisms there is a great deal of uniformity. But that has been done and the standards have been set through the National Association of Insurance Commissioners and not necessarily individually through State legislative jurisdictions.

Mr. WASHBURN. If I could also respond, in a way we are not as weak as our weakest link, but as strong as our strongest because an insurance company who operates on a multistate basis not only gets the domestic commissioner looking at him but also, as an example, in Illinois we have our own series of tests in addition to the NAIC tests that look at all the insurance companies that operate in Illinois and we corresond to the domestic commissioner as to how we view his companies. The same things happen in terms of the marketplace, the consumer information. We will often do joint consumer looks at how a company operates with its consumers.

So in a lot of cases there is a dual look because of the State jurisdiction system that you might not get any other way.

Senator DODD. Let me if I can, very quickly, Mr. Focht, your testimony was very detailed and we appreciate that very much, but I must tell you in going over it and asking myself, well, how does it actually work? I presume I might be a minority of one on this committee on this particular problem, but I wonder if you just might explain what happens to the small investor and the large investor when a brokerage house fails. What do you do? In very clear terms, what do you do?

Mr. FOCHT. You mean an explanation of the customer protection proceeding?

Senator DODD. Yes.

SIPC PROCEDURE IN FAILING BROKER-DEALERS

Mr. FOCHT. Basically when SIPC is advised that a member of SIPC is in or approaching financial difficulties—and I say we are advised because as our statement indicates, we do not have inspection and examination authority over our members. We rely on the work done by the SEC and the self-regulatory organizations. When we are advised that a member of SIPC is in or approaching financial difficulty, we will acquire additional information on that firm. If we conclude that that firm has failed or is in danger of failing to meet its obligations to its customers and one of four conditions specified in the statute is present and we would then go to a U.S. district court, file an application for the appointment of a trustee. If the court makes the necessary adjudication, the court would then appoint a trustee and the proceeding, in effect, Senator, becomes a highly specialized bankruptcy proceeding.

The significant difference between it and a proceeding under the bankruptcy code is that SIPC funds are available for advances to the trustee so that he can satisfy the claims of customers within the limits of SIPC protection. Currently that's $500,000 per account, no more than $100,000 of which may be a claim for cash as opposed for a claim for securities.

The trustee will then process those claims and satisfy them with both SIPC advances and, of course, the assets which he may be able to marshal in the estate.

We find through our 189 proceedings to date that the limits of SIPC protection—and, Senator, they have gone up over the years—they started out at $50,000 and they are now at $500,000 per account—that those limits have fully satisfied the vast majority of the customer claims that we have been presented with.

Senator DODD. What percentage of those?

Mr. FOCHT. We estimate there are 190,000 customer claims in all of our cases and I believe it is something under 300—I believe the number was 269—that had not been fully satisfied with the SIPC advance and the available proration of assets at the firm.

Obviously, one of the trustee's major jobs is to marshal assets that he can, just as any trustee of bankruptcy would do. The problem is, of course, that that takes a great deal of time. The theory is that the SIPC advance of $500,000 will make that customer whole, at least if his claim is within that limit, and then SIPC of course is subrogated to that customer's claim and SIPC is the institution that waits for sometimes years until we find out what a proration of available assets is.

Senator DODD. Thank you very much. I appreciate your comments.

I think Senator Proxmire asked the purpose for these hearings is obviously to deal with the situation that he identified. I wonder if we might just ask—I'd like to ask all of you to give that question some additional thought. I think sometimes it's difficult just getting a question in open hearing and to respond quickly to it. It's the most pointed question. While we realize that you're not directly involved in depository insurance in the sense we're talking about it here, I think it would be tremendously helpful to the committee if you could give that some additional thought on how we might approach that. You're a body of expertise that we can, I think, valuably draw upon and I would request, Mr. Chairman, that our panel here respond, in addition to their verbal testimony, with regard to that question and give us some written responses as well as to that particular point he raised.

I thank all of you for being here today.

The CHAIRMAN. Thank you very much.

Senator D'Amato.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. This morning the Banking Committee continues its indepth examination of the adequacy of Federal insurance funds. To date, the hearings conducted by the committee have focused upon the adequacy of depository insurance funds maintained and managed by the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation. Today's hearing will emphasize two other forms of Federal insurance programs—the Pension Benefit Guaranty Corporation [PBGC] and the Securities Investor Protection Corporation [SIPC]. We will also discuss the adequacy of State guaranty funds in the areas of health, life, property, and liability insurance.

Although the PBGC and SIPC have received less publicity than the FDIC or the FSLIC, they merit our consideration because of the important purpose they serve in insuring funds invested in pension plans or through securities firms. Recently, concerns have been expressed regarding the adequacy of both the PBGC and SIPC funds. Specifically, issues regarding the adequacy of the PBGC's fund have arisen due to administration proposals that would replace the PBGC with private insurers. If the substitution of the PBGC with private insurers is an economically viable alternative, then it deserves our consideration. However, the replacement of the PBGC may be ill advised if private insurers could provide protection for all employee plans by charging reasonable premiums in much the same manner as presently provided by the PBGC. Due to the number of underfunded pension plans it appears that the fund may be inadequate. Therefore solutions such as the charging of risk-based premiums may provide better solutions than the privatization of the PBGC's function. These are issues that we will explore in greater detail this morning.

SIPC plays a valuable role in maintaining public confidence in our securities markets by assuring that customers of failed broker-dealers receive the full value of their assets. The SIPC fund which protects investors is financed by member assessments. Due to the recent increases in the number of investors and funds that they have invested that are covered by SIPC, and increases in the number of failed securities firms since 1981, questions concerning the adequacy of the fund have arisen. This morning we will examine the adequacy of the SIPC fund in relation to the assets that it insures and determine what, if any, congressional action may be necessary to ensure that SIPC is sufficiently funded.

I look forward to the testimony of this morning's witnesses and any suggestions that they may offer regarding the role of the private sector in providing deposit insurance, the role of State guaranty associations that provide funds for policyholders in the event of a failure, and the reform of the deposit insurance system.

The CHAIRMAN. Senator Mattingly.

STATEMENT OF SENATOR MACK MATTINGLY

Senator MATTINGLY. I commend the chairman for continuing the oversight hearings on deposit insurance reform. As the chairman points out, a healthy deposit insurance system is essential to continued confidence in our banking system. I look forward to reviewing the testimony from the witnesses today. Hopefully, we can learn from their experiences in our effort to ensure a strong deposit insurance system. Mr. Chairman, I will have some questions for the record.

The CHAIRMAN. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its oversight hearings on deposit insurance issues. We have a distinguished group of witnesses before the committee this morning. I want to take particular note of John Washburn, the director of insurance for the State of Illinois. I'm sure the committee will find his testimony to be informative and useful.

I understand that today's witnesses will be providing the committee with information on efforts to establish property and liability guarantee funds in the insurance industry, guarantee the payment of claims on insolvent companies, on the Pension Benefit Guarantee Corporation, and on the Securities Investor Protection Corporation. I think the committee will greatly benefit from the views of these experts from other industries. The protection systems in these industries have real relevance to our examination of banking industry deposit insurance issues.

I am here this morning to learn. I look forward to hearing from this morning's panel.

The CHAIRMAN. We thank you very much for your willingness to share your experience with us today as we struggle with what to do with FSLIC and FDIC. Thank you very much.

The committee is adjourned.

[Whereupon, at 11:25 a.m., the hearing was adjourned.]

[Response to written questions of the committee follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM EDWARD MUHL AND JOHN WASHBURN

Q. 1. After the experiences of state depository insurance funds in Ohio and Maryland do you believe that all depository insurance should be provided by the federal government rather than by the states or private insurers?

A. We believe that all depository insurance for banks and savings and loan associations should be done through a mechanism of the federal government and not through the states.

Q. 2. Why do you believe that state insurance guaranty funds covering property, liability, life and health insurance businesses will fare any better than state depository insurance funds?

A. There are a number of reasons why state Insurance Guaranty Funds covering Property and Liability insurance and Life and Accident and Health insurance will fare better than the state depository insurance funds. First of all, all companies that do business in a state must belong to state Insurance Guaranty Fund Associations. They have no alternative if they wish to continue doing business in the state. This gives each state Fund a large stable base for assessment purposes to handle insolvent insurance companies. Also, all of the obligations of the insolvent insurance company do not have to be met at once. While it necessarily varies for each insolvency based upon the type of business they were doing, the Guaranty Association will have a year or two before it is required to perform on all of the company's obligations for unpaid claims. In addition, the state Insurance Guaranty Fund's obligations to the policyholders and claimants of the demised company are not unlimited. The Guaranty Association's obligations for claims are capped at some amount and there usually is a deductible for unearned premium claims. Since many states have passed so called Early Access laws, the Guaranty Funds may utilize the assets of the company to meet obligations to policyholders thereby diminishing the need for assessments on member companies. There are, of course, other differences; but, we believe we have mentioned the principle ones. To date, we are not aware of any state Insurance Guaranty Fund that has been unable to perform in meeting the obligations of an insolvent Property and Casualty insurance company. In fact, we have not even come close to reaching the capacity which currently exists nationally through state Insurance Guaranty Funds for Property and Casualty companies. Once the Life and Accident and Health side of business recent changes mentioned by Director Washburn in his statement will greatly enhance capacity.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM EDWARD MUHL AND JOHN WASHBURN

Q. 1. Recently, the Federal Reserve has proposed to base capital adequacy standards on risk factors and to include off-balance sheet items in the calculation of risk. The commercial banks have argued that higher capital ratios will make them less competitive with other providers of financial services such as insurance companies or securities firms.

What is your general impression about the levels of capital maintained by commercial banks compared with insurance companies and securities firms. Are the banks over-regulated or under-regulated?

A1. We are not informed about the levels of capital maintained by commercial banks and securities firms; therefore, we cannot make the comparison with insurance companies which the question requests. Similarly, we cannot respond to the question of whether banks are over regulated or under regulated since we are not informed about the scope and manner of bank regulation in sufficient detail. One observation we can make is that there seems to be a number of agencies at the federal level involved in bank regulation including the Federal Depository Insurance Corporation, Comptroller of the Currency and the Federal Reserve, and perhaps others. Having some experience with coordinating regulatory activity at the state level, we wonder if some consolidation might be in order.

Also, we would like to offer some comments on the current proposal to base capital adequacy standards for banks on risk factors. As you may be aware, insurance companies, particularly Property and Casualty companies, are generally required in some instances by state law or in others by administrative requirements, to maintain a certain relationship between its premium writings and its capital. This in insurance parlance, is called the risk ratio. Normally, a three to one ratio is deemed acceptable. In other words, a company can write business equal to any amount three times its capital. If a company is involved in more volatile lines such as certain classes of commercial liability insurance or medical malpractice insurance, a company will be required to maintain a risk ratio of say, two to one. Similarly, if a company is involved in more predictable and less volatile lines such as property insurance, a company would be allowed to increase writings to a level of say, four to one. We believe there is a growing trend in the insurance regulatory field towards expanding this sort of requirement to Life insurance and Accident and Health insurance companies, as well as, improving the manner in which the determination of what the risk retention ratio should be for a particular company so that it is less subjective. Thus, we support the notion of basing capital requirements for banks based on risk factors. This will not be an easy task. However, in designing such a system, it should be kept in mind that the system should not inhibit innovation and should recognize the dynamic features of financial service entities. Also, it must not inadvertently encourage inaccurate reporting of financial position or results.

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Office of the Executive Director

April 17, 1986

MEMORANDUM FOR

Mr. Edward M. Malan
Senate Committee on Banking,
Housing and Urban Affairs

SUBJECT: Responses to Questions from Senator D'Amato

Attached are responses to the questions raised by Senator D'Amato which you recently sent us. Please note that they were written to reflect the situation of the PBGC at the time of the Senate Banking Committee hearings on deposit insurance in February. Since that time, the budget reconciliation bill, which gives the PBGC's single-employer program a much-needed premium increase and reforms, has been enacted.

Kathleen P. Utgoff
Kathleen Utgoff
Executive Director

Attachment

KATHLEEN UTGOFF

Responses to Questions from Senator D'Amato Relating to Oversight Hearing on Deposit Insurance Senate Banking Committee

Q 1. Recently we have witnessed the inadequacy of state insurance funds designed to guaranty deposits in state chartered S&L's. The experiences of the Ohio and Maryland funds have also caused private insurers of these funds to exit from this business. In light of the recent experiences of state and private deposit insurers, do you believe that private insurance of pension funds is feasible?

A 1. Private insurance of defined benefit pension plans is feasible. If insurance were available from private carriers, almost the entire population of PBGC-covered plans would qualify for coverage at modest premium rates. Insurers would have to set standards of insurability just as they do for other types of insurance. No doubt some plans would not qualify for the insurance because of inadequate funding and/or financial weakness of the company maintaining the plan. Special arrangements would have to be made to assure that the benefits of participants and beneficiaries in these plans are protected.

Q 2. If private insurers were allowed to insure pension funds, should they be able to charge premium rates according to risk or should employers be charged a flat premium rate? At present, federal pension insurance charges all funds a flat rate premium. Should we consider allowing the PBGC to charge a risk-related premium?

A 2. Private insurance companies set premiums based on risk. If pension plan termination insurance were provided by private companies, they would presumably set risk-based premiums for the insurance. A risk-based premium allows sharing of losses among insureds with similar risk characteristics. It also rewards the less risky insureds with a lower premium rate. In the case of pension plans, better funding of plan liabilities would result in lower premiums.

A risk-related premium structure should be considered for the PBGC's single-employer program. The PBGC is studying the issue. Once a legislative reform package has been enacted for this program, we will be able to complete our study.

Q 3. Would the ability to charge a risk-related premium alleviate the financial strain on the PBGC?

A 3. No. The purpose of a risk-related premium is to allocate total premium revenue among insured plans. Establishing the total premium revenue to be collected is an independent decision. Therefore, institution of a risk-related premium for the PBGC would not, by itself, help the PBGC to improve its financial condition. A premium increase is still needed.

Q 4. The Reagan Administration has advocated a shift from the insurance of pension funds by the federal government to the private sector. What evidence can you cite to demonstrate the existence of private sector participants in this type of insurance?

A 4. There is some misunderstanding, stemming from a newspaper article on the subject, about the extent to which the Administration has considered "privatizing" the PBGC's insurance function. In fact, there have been no PBGC or Administraiton position statements or proposals in this area. However, the PBGC's Advisory Committee, pursuant to a recommendation of the Grace Commission, is examining the issue. A report is planned for this summer.

As for private carrier interest in providing pension plan insurance, it is too early to make an assessment. The degree of interest will depend on the design of the program and, in particular, the flexibility to select risks and set premiums.

Q 5. If the PBGC is presently operating at a deficit, isn't the simplest solution to increase premiums? If private insurers replaced the PBGC wouldn't their first act be to raise premiums since they could not afford to operate at a deficit?

A 5. The PBGC's deficit cannot be eliminated without a premium increase unless funding is obtained from some other source, such as general revenue financing. If private insurers were to take over all of the PBGC's assets and liabilities, then they would have to raise premiums.

It is possible to shift the insurance function to private companies for future terminations only, and to separately fund the existing deficit. Even so, if all plans were transferred to the private sector, a premium increase would still be needed. The current $2.60 premium is not enough to fund even future claims and administrative expenses.

Q 6. What are the premiums the PBGC presently charges employers? By what amount would these premiums increase if the PBGC wished to eliminate its deficit?

A 6. The PBGC's two insurance programs, the single-employer program and the multiemployer program are separately funded and the funds from one cannot be used for the other. The current premium is $2.60 per participant per year for the single-employer program. In order to fund the existing $1.3 billion deficit over a 15-year period and future claims and administrative expenses as they are incurred, we would need a premium of about $13.50.

The premium in the multiemployer program is currently $1.80 and is scheduled to increase, by $.40 every other year, to $2.60 for plan years beginning on or after September 27, 1998. No increase is needed in this program.

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April 25, 1986

Mr. Ed Malan
Committee on Banking, Housing
and Urban Affairs
United States Senate
Dirkson Senate Office Building
Room 534
Washington, D.C. 20510

Dear Mr. Malan:

As a result of my testimony before the Senate Committee on Banking, Housing and Urban Affairs on January 22, 1986, Senators D'Amato and Mattingly posed certain questions which were submitted to us under cover of an undated letter from Mr. Bealefeld, which we received on April 10, 1986.[1] Mr. Bealefeld asked that I send our responses directly to you.

Set forth below are the Senators' questions and our responses.

Question 1 from Senator D'Amato

Page 3 of your testimony implies that creditors stand in the same position as customers in a SIPC proceeding. In a SIPC proceeding are general creditors of the failed broker-dealer satisfied through the use of SIPC funds, or are customers only able to be satisfied through the use of SIPC funds?

Answer

This question apparently refers to the following sentence in my testimony: "The proceeding looks not only to the claims of customers, but also the claims of general creditors." All I meant by that statement was that a liquidation proceeding under the Securities Investor Protection Act ("SIPA") is, in essence, a bankruptcy proceeding which deals with all claims against the failed broker-dealer, not just the claims of customers. General creditors cannot receive funds advanced by SIPC. SIPC's funds may be used to pay the claims of customers and, where the general estate is insufficient, to pay administrative expenses. The priorities of distribution of the general estate set forth in section 726 of the Bankruptcy Code are applicable in a SIPA proceeding.

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[1] Apparently these questions were sent to us earlier, but we have no record of having received them.

Question 2 from Senator D'Amato

On page 4 of your testimony you mention that certain amendments to the Bankruptcy Code of 1984 have created confusion regarding the ability of a Bankruptcy Court to preside over a SIPC liquidation. What type of legislation is needed to resolve any ambiguities created by the Bankruptcy Code?

Answer

Liquidation proceedings under SIPA are initiated by SIPC's filing an application for the appointment of a trustee in the United States District Court. Once the District Court appoints a trustee, the liquidation proceeding is, in essence, a straight bankruptcy proceeding conducted in accordance with the provisions of SIPA and many of the provisions of the Bankruptcy Act or the Bankruptcy Code. Before 1978 some District Judges retained jurisdiction over the liquidation proceedings, which were then conducted in the United States District Court. Many other District Judges referred the liquidation proceedings to the bankruptcy referees. Our experience over the years and in scores of liquidation proceedings led us to conclude that, because of the bankruptcy nature of SIPA liquidation proceedings, the bankruptcy referees, rather than the District Judges, were better equipped to deal with SIPA liquidation proceedings. In 1978, as part of the Bankruptcy Reform Act, SIPA was amended so as to require that, once the District Court had appointed a trustee, the liquidation proceeding must be removed to the Bankruptcy Courts which had been established under the Bankruptcy Reform Act. The statutory language chosen to accomplish this removal requires the District Court to order the removal of the entire liquidation "to the Court of the United States in the same judicial district having jurisdiction over cases under title 11." The court having jurisdiction over cases under title 11, pursuant to the Bankruptcy Reform Act, was the Bankruptcy Court. But under the 1984 amendments to the Bankruptcy Code, it is now the District Court that has such jurisdiction. Thus, the removal provision in SIPA, if read literally, would require the District Court to order the removal of a liquidation proceeding to itself. As a direct result of this statutory confusion, the Bankruptcy Court for the District of Colorado held several months ago that bankruptcy judges have no authority to decide matters under the Securities Investor Protection Act. A copy of that opinion, which is presently on appeal, is attached for your convenience. The relevant pages of the opinion are pages 13-18.

In order to remedy this problem, Senator D'Amato introduced S. 922 on April 16, 1985. A similar bill, H.R. 1346, was introduced by Congressman Dingell. Unfortunately, these bills do not appear to have made any progress through the legislative process.

Question 3 from Senator D'Amato

Is the SIPC fund adequate? At present a flat fee is levied against all SIPC members to finance the fund. Is this flat fee fair or should a risk related premium payment be utilized?

Answer

SIPC has studied these questions on a number of occasions. Attached hereto is a copy of a report issued in November, 1985 by a Task Force convened by SIPC and broadly representative of the securities industry and its regulators. On the basis of that report and other information available to it, SIPC's Board of Directors determined that SIPC's fund, which presently exceeds $340 million, is adequate. This is the highest fund level in SIPC's history, and is more than double the statutory minimum.. In addition, SIPC has a confirmed line of credit of $500 million with a consortium of banks and authority to borrow up to $1 billion from the United States Treasury. Thus, SIPC has available to it over $1.8 billion. In its 15-year history, with the fund at much lower levels, SIPC has never had to borrow from any source in order to carry out the program of customer protection established by SIPA.

The issue of the use of a risk related premium has arisen from time to time and has been studied on numerous occasions. No feasible formula has been suggested, and our experience with broker-dealer failures has not provided any guidelines. The present flat fee of $100 per year is a token assessment primarily intended to keep the assessment mechanism in place. It is not intended to provide a significant source of revenue for the fund. This matter is discussed further in the answer to question 6 from Senator D'Amato.

Question 4 from Senator D'Amato

The House has passed and the Senate is considering legislation that would require the registration of previously unregistered broker-dealers who are exempted from the registration requirements of the Securities and Exchange Act of 1934 because they dealt exclusively in government securities. Should government securities dealers who were previously exempted from registration requirements be required to contribute to the SIPC fund or should they be treated as they have in the past?

Answer

Broker-dealers dealing exclusively in government securities have not and are not required to register under the Securities Exchange Act of 1934 and are not, therefore, subject to the existing regulatory environment. Since the SIPC program relies on the inspection and surveillance of broker-dealers provided by that regulatory structure, presently exempt broker-dealers should not be included in the SIPC program unless some equally effective regulatory structure is provided. If circumstances are such that customers of previously exempt broker-dealers are included in the protections provided by the SIPC program, then questions of funding and assessments for such firms would have to be addressed.

Under the House bill, government securities broker-dealers, although required to be registered, will not be members of SIPC. H.R. Rep. No. 99-258, 99th Cong., 1st Sess. 25 (1985). Accordingly, questions of funding and SIPC assessments for such firms will not arise.

Question 5 from Senator D'Amato

How carefully does SIPC monitor the representatives [sic] to customers that a broker-dealer is a member of SIPC? Are you aware of any situations where customers have been misled by a firm that represents that it is a member of SIPC when in fact a subsidiary of that firm maintains the relationship with the customer and the subsidiary is not a member of SIPC? In these situations, would customers be covered by SIPC?

Answer

SIPC has no regulatory authority over its members. Regulation and examination for compliance with applicable financial responsibility rules are provided by the Securities and Exchange Commission and the self-regulatory organizations. SIPC is, however, aware of a number of instances where customers who thought they were dealing with a SIPC member were, in fact, dealing with another non-SIPC part of a larger corporate group. We have recently discussed these matters with representatives of the Securities and Exchange Commission and the National Association of Securities Dealers, Inc., and we expect to have continuing discussions in the hope of finding effective means for dealing with this problem.

Whether customers are entitled to SIPC protection in situations such as the ones described in this question will depend upon the findings of fact and conclusions of law reached by the court which is making determinations with respect to the claims. It is not possible to know in advance what the final court determination may be.

Question 6 from Senator D'Amato

On pages 9 and 10 you provide an explanation of your proposed bylaw regarding member assessments to augment the fund. Why was this bylaw proposed? Has the $100 assessment proven inadequate? What has been the response to this bylaw from the broker-dealer community? Has the SEC commented on the bylaw and if so what is the Commission's position?

Answer

In answering question 3 of Senator D'Amato, we attached hereto a copy of the Report to the Board of Directors of the Securities Investor Protection Corporation by the Special Task Force to Consider Questions Relating to the SIPC Fund and Assessments. That report is the progenitor of the bylaw. As noted in response to question 3, SIPC's Board of Directors has determined that the present size of the SIPC fund, together with a $500 million line of credit, is adequate. It therefore determined that, effective April 1, 1986, SIPC would stop assessing its members at the rate of ¼ of 1% of gross revenues from the securities business per annum. Instead, it has imposed a flat fee of $100 per member, basically as a means of keeping the assessment mechanism intact. The other bylaw changes, some of which are statutorily mandated, are simply designed to automatically re-impose assessments based on a percentage of gross revenues from the securities business in the event that the SIPC fund is drained to a point where that seems advisable. As required by statute, the proposed bylaw was submitted to the Securities and Exchange Commission. The Commission requested public comment on the proposed bylaw in SIPA release No. 128 (December 24, 1985), and by publication in the Federal Register, 50 Fed. Reg. 53044 (December 27, 1985). Only one comment letter -- from the Securities Industry Association -- was received. That letter strongly supported the proposed changes. The Securities and Exchange Commission found that the bylaw was in the public interest and was consistent with the provisions of SIPA, and, accordingly, approved its adoption on January 21, 1986. See 51 Fed. Reg. 3526 (January 28, 1986).

Question 1 from Senator Mattingly

Mr. Focht, is my understanding correct that if the customer of a broker-dealer decides to transfer to or leave excess cash in his account with the broker-dealer solely for the purpose of earning interest, then he will have no protection from SIPC with respect to that cash if the firm fails? If he wants to earn interest on whatever excess cash he has, should he not then go to a bank and buy a CD or deposit his money there which will be insured against loss up to $100,000 by the FDIC?

Answer

The purpose of SIPA is to increase investor confidence in the securities markets by protecting participants in the securities markets against loss caused by the financial failure of stockbrokers. Thus, SIPA protects persons who have deposited cash with a broker-dealer for the purpose of purchasing securities. It does not protect persons who are not involved in the securities markets but who, in essence, use their broker-dealers as banks, leaving money there solely for the purpose of earning interest. For purposes of determining whether persons creating or maintaining interest-bearing free credit balances at stockbrokers are protected customers under SIPA, SIPC has adopted and publicized the following policy:

> "Cash balances are protected under the Securities Investor Protection Act if the money was deposited or left in a securities account for the purpose of purchasing securities. This is true whether or not the broker pays interest on the cash balances. Of course, cash balances maintained solely for the purpose of earning interest are not protected.
>
> SIPC presumes that cash balances are left in securities accounts for the purpose of purchasing securities. It would require substantial evidence to the contrary to overcome this presumption.

> Standing alone, the fact that a cash balance was earning interest and was not used to purchase securities for a considerable period of time, say several months, would not be sufficient to overcome the presumption."

In addition, the Securities and Exchange Commission has issued its release No. 34-18262, a copy of which is attached. That release explains the law concerning interest-bearing free credit balances in some detail.

If you have any further questions, please do not hesitate to write to me.

Very truly yours,

Theodore H. Focht

Theodore H. Focht
President and General Counsel

THF:ges

Attachments

REPORT TO THE BOARD OF DIRECTORS OF THE
SECURITIES INVESTOR PROTECTION CORPORATION

by the

SPECIAL TASK FORCE TO CONSIDER QUESTIONS
RELATING TO THE SIPC FUND AND ASSESSMENTS

NOVEMBER, 1985

INTRODUCTION

The Special Task Force to Consider Questions Relating to the SIPC Fund and Assessments is pleased to submit this report and recommendations to the SIPC Board of Directors. This eighteen member Task Force appointed by the SIPC Board is broadly representative of the securities industry:

Six are SIPC members
Seven represent self-regulatory organizations
Two represent industry associations
Two are from U.S. Government agencies
One is from the SIPC staff

Members' names and their affiliations are given at the end of the report.

Responsibilities of the Task Force

The SIPC Board requested the Task Force to consider the following questions:

1. What recommendation does the Task Force have with respect to the level of the SIPC Fund?

2. What assessment structure should be used to achieve the Fund level in 1. above?

3. What assessment structure should be used after the SIPC Fund has reached the level recommended in 1. above?

4. What recommendation does the Task Force have with respect to SIPC commiting a sum of money to fund a public relations/advertising campaign to make the public more aware of the SIPC program?

At its organizational meeting on July 9, 1985, after a general discussion of the SIPC Fund and assessments a subcommittee was formed to consider questions 1, 2 and 3 (above). This subcommittee, three industry members and three representatives of self-regulatory organizations, consisted of Mr. Joseph A. Vitanza, Chairman, and Messrs. Jay Conefry, Jr., Charles J. Henry, Kenneth R. Liebler, Kenneth I. Rosenblum and John A. Wing.

The delineation of the issues by this subcommittee enabled the Task Force to focus on the key elements of this study and facilitated the development of the discussion and recommendations contained in this report.

RECOMMENDATIONS

1. THAT SIPC INCREASE THE RESOURCES AVAILABLE TO PROTECT CUSTOMERS OF ITS MEMBERS BY ESTABLISHING A $500 MILLION BANK LINE OF CREDIT.

2. THAT A SIPC FUND LEVEL OF $300 MILLION COMBINED WITH A $500 MILLION BANK LINE OF CREDIT WILL PROVIDE ADEQUATE PROTECTION AT THIS TIME AND ASSESSMENTS BASED ON GROSS REVENUES SHOULD BE DISCONTINUED AS OF DECEMBER 31, 1985.

3. THAT UPON DISCONTINUANCE OF THE ASSESSMENTS BASED ON GROSS REVENUES SIPC MEMBERS DOING A PUBLIC BUSINESS PAY MINIMUM ANNUAL ASSESSMENTS OF $150 AND THAT ALL OTHER MEMBERS PAY MINIMUM ANNUAL ASSESSMENTS OF $25 FOR EACH CALENDAR YEAR.

4. THAT AFTER THE ADOPTION OF THE MINIMUM ANNUAL ASSESSMENTS ANY FUTURE ASSESSMENTS BASED ON GROSS REVENUES SHOULD COMMENCE, AS REQUIRED BY SECTION 78ddd.(d)(1)(B) OF THE SIPA, AFTER THE SIPC FUND HAS FALLEN BELOW $150 MILLION.

5. THAT SIPC COMMIT NO FUNDS TO AN ADVERTISING CAMPAIGN TO MAKE THE PUBLIC MORE AWARE OF THE SIPC PROGRAM.

6. SIPC SHOULD CONTINUE ITS PRESENT POLICY OF REVIEWING WITH THE SECURITIES AND EXCHANGE COMMISSION ("SEC") AND SELF-REGULATORY ORGANIZATIONS ("SROs") ALL FRAUDULENT OR SUSPECTED FRAUDULENT ACTIVITIES AND OTHER AREAS WHICH HAVE CONTRIBUTED TO THE FAILURE OF SIPC MEMBERS WITH A VIEW TO THE DEVELOPMENT OF BETTER SURVEILLANCE PROGRAMS AND TECHNIQUES TO AID IN THE EARLY DETECTION OF ABUSES OF FINANCIAL RESPONSIBILITY RULES PARTICULARLY RULE 15c3-3 WHICH IS DESIGNED TO PROTECT THE INTEGRITY OF CUSTOMER FUNDS AND SECURITIES.

7. SIPC SHOULD CONTINUE TO COMMUNICATE WITH THE SEC AND THE SROs TO EMPHASIZE THE NEED FOR MORE STRINGENT AND EFFECTIVE PENALTIES WITH A VIEW TOWARD BARRING FROM THE SECURITIES INDUSTRY THOSE PERSONS FOUND GUILTY OF IMPROPER ACTIVITIES WHO HAVE CONTRIBUTED TO THE FAILURE OF SIPC MEMBERS.

8. SIPC SHOULD CONTINUE TO ENTER CIVIL SUITS AGAINST PERSONS AND ORGANIZATIONS THAT HAVE CAUSED SIPC MEMBERS TO BECOME SUBJECT TO CUSTOMER PROTECTION PROCEEDINGS UNDER THE SIPA.

9. SIPC SHOULD APPOINT A NEW TASK FORCE PERIODICALLY TO REVIEW THE FUND LEVEL, THE LINES OF CREDIT, THE ASSESSMENT STRUCTURE AND THE POTENTIAL IMPACT ON THE SIPC PROGRAM OF NEW PRODUCTS DEVELOPED BY THE SECURITIES INDUSTRY.

BACKGROUND

Statutory requirements concerning the SIPC Fund and assessment structure (Exhibit A)

Under the provisions of the Securities Investor Protection Act of 1970 ("SIPA") and SIPC's bylaws, SIPC members are currently paying assessments at the rate of 1/4 of 1% of their respective gross revenues from the securities business, with a minimum of $25.00 per annum.

SIPA requires SIPC members to pay assessments at the rate of 1/4 of 1% per annum of their gross revenues whenever the Fund is less than $150 million and at the rate of 1/2 of 1% whenever the Fund balance is below $100 million.

The minimum assessment for each member may be up to $150.00 per annum.

History of the SIPC assessment structure

1971 Initial assessment: 1/8 of 1% of each member's gross revenues from the securities business during the calendar year 1969. Minimum assessment $150.00.

1972 through December, 1977: 1/2 of 1% of gross revenues. No minimum.

January, 1978 through June, 1978: 1/4 of 1% of gross revenues. No minimum.

July, 1978 through December, 1978: No assessment.

-January, 1979 through April, 1983: $25.00 per annum uniform assessment for each member.

May 1, 1983 to present: 1/4 of 1% of gross revenues. $25.00 minimum. (The $25.00 assessment paid in the first four months of 1983 was applied by each member to its fiscal period that ended in or after January, 1983.)

On September 21, 1983 the SIPC Board determined that the assessment rate of 1/4 of 1% would be maintained until the Fund aggregated $300 million. SIPC's bylaw Article 6 [Section 1(a)(1)] provides that the assessment rate will continue at 1/4 of 1% "until such time as the Board provides otherwise."

Growth of SIPC membership

SIPC membership has grown from 3,994 as of December 1971 to 10,700 as of June 30, 1985. This is an increase of 6,706 members (168%).

December 31	No. of members	December 31	No. of members	December 31	No. of members
1971	3,994	1976	5,168	1981	7,176
1972	3,756	1977	5,412	1982	8,082
1973	3,974	1978	5,670	1983	9,260
1974	4,238	1979	5,985	1984	10,338
1975	4,372	1980	6,467	1985 (June)	10,700

Approximately 1,200 of the current members are carrying customer accounts. Much of the growth in the membership has resulted from the number of members engaged in the listed options business (beginning in 1973) and the increase in the members engaged primarily in the sales of special products such as limited partnership interests (tax shelters).

History of the SIPC Fund

Pursuant to Section 78ddd.(a)(2) of SIPA the SIPC Fund consists of cash, amounts invested in U.S. Government or agency securities and (before 1978) confirmed lines of credit.

The SIPC Fund
(000's omitted)

Year	Lines of Credit	Dec. 31 Total	Net Change during period (decrease)
1971	$65,000	$ 91,505	$ 91,505
1972	55,000	104,978	13,473
1973	45,000	84,785	(20,193) (a)
1974	35,000	95,165	10,380
1975		81,679	(13,486) (b)
1976		116,154	34,475
1977		152,446	36,292
1978		175,653	23,207
1979		194,215	18,562
1980		208,426	14,211
1981		166,731	(41,695) (c)
1982		172,882	6,151
1983		174,212	1,330 (d)
1984		246,101	71,889
1985 (July 31)		300,836	54,735

(a) $22.4 million advanced in the Weis Securities, Inc. liquidation and lines of credit reduced by $10 million.
(b) $25 million lines of credit terminated 9/17/75 by Board action.
(c) Ten proceedings were commenced in 1981. Nine required SIPC advances of $63.8 million by year end.
(d) The SIPC Fund decreased to below $150 million in April 1983 and, as required by SIPA, assessments at the rate of 1/4 of 1% of gross revenues from the securities business were commenced effective May 1, 1983.

Limits of SIPC advances and net advances through June, 1985

	No. of Proceedings	Limits: Total Claims	Limits: Cash Claims	Net Advances
1971 - May 1978	129	$ 50,000	$ 20,000	$ 47,561,945
May 1978 - October 1980	13	100,000	40,000	2,682,150
October 1980 - June 30, 1985	41	500,000	100,000	117,916,576*
	183			$168,160,671

* includes SIPC's two most expensive proceedings to date--both the result of large scale fraud:

Bell & Beckwith	$39,320,945
Stix & Co., Inc.	20,332,905
	$59,653,850

Net advances in five year increments through June, 1985

Period	No. of Cases	Net Advances: Total	Net Advances: Average per year	Net Advances: Average per case
1971-1975	117	$ 40,049,161	$ 8,009,832	$ 342,301
1976-1980	26	10,387,899	2,077,580	399,535
1981-6/30/85	40	117,723,613	26,160,803	2,943,090
Deduct: B & B + Stix	(2)	(59,653,850)		
1981-6/30/85 Excluding B & B + Stix	38	58,069,763	12,904,392	1,528,152

SIPC members with advances over $2 million through June, 1985

Through June 30, 1985 there were 183 SIPC proceedings commenced. Fourteen (7.7%) of these each required advances of more than $2 million and had net advances of $111 million. This is 66% of total net SIPC advances of $168 million. Criminal action for fraud has been initiated in seven of these proceedings that have required net SIPC advances of $78.3 million (47%) of total net advances.

Distributions to customers and administration expenses in 128 completed liquidations through 1984

In the 128 liquidations completed through 1984, trustees distributed $271 million of securities value and cash for accounts of customers. Debtors' estates provided $246 million (91%) and $25 million (9%) were from SIPC advances.

The administration expenses in the 128 completed cases totaled $30 million. Debtors' estates provided $22 million (73%) and $8 million (27%) were from SIPC advances.

Growth of the Securities Industry

The growth of the securities industry as reflected by the increase in capital and revenues in recent years of the New York Stock Exchange firms doing a public business.

NYSE Firms Doing A Public Business
($ Millions)

Quarter	Total Capital	Equity Capital	Year	Total Revenue
4Q 1984	$16,848	$12,751	1984	$31,216
4Q 1980	6,835	5,359	1980	16,020
4Q 1975	3,500	2,721	1975	5,927
4Q 1972	4,212	3,173	1972	5,995

It is interesting to note that in 1984 the total capital is four times that reported in 1972, the equity capital is also four times greater than in 1972 and the total revenue is five times that reported for 1972.

Some comparisons of SIPC's history with the growth of the securities industry follow:

> From its inception (December 30, 1970) through June 30, 1985 (fourteen and 1/2 years) SIPC has made net advances in customer protection proceedings of $168 million. By multiplying the net advances by a factor of four, using the growth of the industry's capital as a guide, a resource requirement of approximately $672 million is projected.
>
> The SIPA initially required SIPC to assess its members at the rate of 1/2 of 1% of their respective gross revenues until the "balance of the fund aggregates not less than $150 million (or such other amount as the Commission may determine in the public interest)." Multiplying the $150 million by four would project a resource requirement of $600 million.

Customer Protection Proceedings - 1985

Eight customer protection proceedings were commenced from January 1 through September 10, 1985. In these proceedings, as in most of the proceedings under SIPA, it has been very difficult in the early stages to determine with any degree of accuracy the number and value of customer accounts, and the amount of customer property available for distribution. Using the available data and informed guesstimates of the SIPC staff there are in these eight proceedings an aggregate of approximately 14,000 customers and potential gross SIPC advances ranging from $35 million to $40 million.

SIPC revenues and expenses-1971 through June, 1985

	(000's omitted)
Assessments & Contributions	$325,888
Interest on U.S. Government securities	175,158
Total	$501,046
Costs of customer protection proceedings	$188,811
Other expenses	26,419
Total	$215,230

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC) FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION (FSLIC) AND SECURITIES INVESTOR PROTECTION CORPORATION (SIPC)

The securities industry is unlike the banking and savings and loan industries. Customer property is protected by the financial responsibility rules and regulations including particularly Rule 15c3-3 that "is well fashioned to furnish the protection for integrity of customer funds and securities as envisioned by Congress when it amended Section 15(c)(3) of the Act by adopting Section 7(d) of the Securities Investor Protection Act of 1970..."*

This Rule 15c3-3 requires broker-dealers to take possession of and maintain control of customer securities and restricts the use of customer funds to the financing of customer receivables or to deposit such funds in special reserve bank accounts for the protection of customers. This substantially differentiates the securities industry from the banking and savings and loan industries. The customer deposits in banks and savings and loan associations are available for managment to lend or invest on a principal basis which frequently places the customer deposits in illiquid assets.

The Task Force concluded it is not appropriate to attempt to relate the size of the SIPC Fund to the value of customer property being held by SIPC members as the FDIC and FSLIC relate their respective funds to the size of their insured deposits.

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* Securities and Exchange Act of 1934, Release No. 9856

DISCUSSION

Factors which indicate a need for an increase in resources to protect customers.

1. There has been an increase in (i) the size of many SIPC members, (ii) the number of customers' accounts carried by such members and (iii) the number and complexity of new products in the industry. All of these factors increase SIPC's potential exposure in a single liquidation proceeding.

2. SIPC's limits of advances to protect individual customers have increased by a multiple of ten. Initially the maximum advance was $50,000 with a limit of $20,000 for cash claims and since October 1980 the maximum has been $500,000 with a limit of $100,000 for cash claims.

3. The cost to SIPC of customer protection proceedings has increased in recent years based on net advances through June 30, 1985. From 1971 to 1975 SIPC's average cost per proceeding was $342,000, from 1976 to 1980 the average cost was $400,000 and from 1981 through June, 1985 the average cost was $2,943,000. Exclusive of Bell & Beckwith and Stix & Co., Inc., the two proceedings requiring the largest net advances to date, the average cost per case during the 1981 to 1985 period was $1,528,000. Based on early information the higher costs per proceeding are attributable to a greater number of customers, increased advances for larger individual claims (SIPC's limits of advances were increased in 1980 to $500,000/$100,000--see 2 above) and higher administration costs. There will be additional advances and possibly recoveries in some of these 1981-1985 proceedings. An analysis of each case will be done as it is completed. Only three small cases begun since 1980 have been closed to date.

4. Fraud has been a significant factor in many SIPC liquidations including the two largest proceedings in terms of SIPC's net advances. These two have net advances of approximately $59.7 million as of June 30, 1985. This is approximately 35.5% of the net advances of $168.1 million in SIPC's entire fourteen and 1/2 years of existence.

Factors which indicate there are more protections for customers in the industry than existed in the past.

5. There has been a significant growth in capital and revenues in the securities industry from 1970 to the present, as reflected earlier in this report. These factors suggest an improvement in the financial condition of many SIPC members thus providing a larger financial cushion for the protection of customers.

6. As SIPC members have grown in size it is not unusual to find they will have established better controls and not infrequently expanded internal audit functions.

7. It is unlikely that a large SIPC member owned by a company that is not a registered broker/dealer would be permitted by the parent company to deteriorate to the point where a SIPC liquidation would be required.

8. Since the inception of SIPC in 1970 there has been a substantial expansion and revision of the rules and regulations governing brokers and dealers - particularly in the area of capital requirements and the requirements for the possession and control of customer securities and restrictions on uses of customer cash.

Conclusions

9. Although the future cannot be predicted with certainty, the Task Force believes SIPC's history of advances in customer protection proceedings appears to offer the best mathematical basis on which to base a recommendation for a fund level to be achieved.

   As noted previously SIPC's net advances in 40 proceedings from January 1, 1981 through June, 1985 amounted to $118 million. This is an average of $26 million per year. With the SIPC Fund at $300 million it would require the equivalent of approximately six years of advances (using the $26 million average) in a very short period of time to reduce the Fund below the $150 million level and thus require assessments based on gross revenues.

   Investments in $300 million of U.S. Government securities at a yield of 8% per annum will produce income of $24 million in one year before the effects of compounding. This is approximately equal to SIPC's average net advances of $26 million per year noted above. Exclusive of net advances in proceedings SIPC's expenses were $3.5 million for 1984 and $2.3 million for the first seven months of 1985.

10. The SIPC Fund level of $300 million approved by the SIPC Board in September, 1983 appears to be a suitable level for the Fund but other resources should be made available for the protection of customers prior to having to borrow from the U.S. Treasury.

11. The Task Force considered recommending the establishment of a $300 million line of credit. This would match the amount of the SIPC Fund already built up by the securities industry and the total resources of $600 million (the Fund plus the line of credit) would be adequate to demonstrate the commitment of SIPC and its members to maintain confidence in the industry.

The recommendation that a $500 million line of credit be obtained was agreed upon by the Task Force because SIPC's current financial condition and its track record will make it relatively easy at this time to obtain such a line. Additionally, in the event of the failure of a very large SIPC member or a series of proceedings which would require borrowings under the line of credit, SIPC would find it difficult and more expensive at that time to obtain an increased line from $300 million to $500 million.

Meetings were held with representatives of four major banks to discuss establishing lines of credit. These discussions resulted in preliminary determinations that a credit line could be established for a three year period with a commitment fee in the range of 1/4 to 1/2 of 1% per annum. Any borrowing under the line of credit would be repaid over approximately a four year period.

The Task Force concluded that SIPC members would much rather have SIPC pay the cost of a bank line of credit than continue assessments at the current rate of 1/4 of 1% of gross revenues. The observation was made that the industry recognizes its responsibility under SIPA to pay future assessments in order to repay any borrowings on the line of credit. Since it is possible that it may never be necessary to draw on the credit line (or until such a borrowing occurs), SIPC members could retain the amounts which they would otherwise pay in assessments, and utilize this capital in their respective businesses.

12. The Task Force recommends that SIPC assessments based on gross revenues be discontinued December 31, 1985. The Fund currently exceeds $300 million. In order to keep the assessment mechanism in place and to generate sufficient assessments to approximately cover the fees for a line of credit it is recommended that minimum annual assessments be paid by SIPC members as follows:

A minimum assessment of $150 per annum on those members doing a public business (subject to audit - approximately 7,000) and $25 per annum on other SIPC members (approximately 3,000) would generate assessments of $1,125,000. The cost of a $500 million line of credit at 1/4 of 1% would be $1,250,000.

Based on 1984 SIPC assessment data, the Task Force recognizes there will be several thousand SIPC members for which a minimum payment of $150 per year will be an increased assessment. There should be a savings in fees of independent accountants, however, since special audited reports on SIPC assessments are not required when only minimum assessments are in effect. Such members should consider a $150 per year assessment a bargain in view of the protections provided for their customers by the SIPC Fund and other resources aggregating $800 million.

13. The recommendation that the SIPC Fund be allowed to decrease to $150 million before re-instating assessments based on gross revenues is based on the following: (i) A Fund of $150 million plus a $500 million line of credit provides a cushion of a $650 million before it would be necessary for SIPC to seek a loan from the U.S. Government (ii) Assessments at a rate of 1/4 of 1% per annum on gross revenues will generate approximately $50 million per year based on current industry revenues (iii) The industry believes it is able to realize a better return on investments than SIPC and (iv) since assessments are not refundable, SIPC members have no desire to place additional cash into the SIPC Fund until there is a statutory requirement to do so.

14. The Task Force believes that as new products are developed it is essential the SROs and the SEC be prompt in evaluating them and developing rules and regulations that will provide adequate safety for the protection of customer property.

Based upon SIPC's experience in customer protection proceedings the Task Force also believes that fraud will continue to be a significant factor causing the failure of SIPC members in the future.

It is for these reasons the Task Force has recommended SIPC continue to work with the SEC and the SROs to improve surveillance programs and techniques, to urge more stringent and effective penalties for violations of rules and regulations, and to enter lawsuits where appropriate and feasible.

15. The December 1983 Executive Summary of the Image and Awareness Study prepared for SIPC by the Decision/Making/Information firm was furnished to all Task Force members. The Task Force considered the question of funding an advertising campaign to make the public more aware of the SIPC program and recommended that such a program not be undertaken by SIPC.

The Task Force urges favorable consideration of these recommendations by the SIPC Board of Directors.

Respectfully submitted,

Lloyd W. McChesney
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Securities Investor Protection
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Chairman, SIPC Special Task Force

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* abstained from voting

Exhibit A

Selected Parts of SIPA Section 78ddd. SIPC Fund

(2) GENERAL ASSESSMENT AUTHORITY

SIPC shall, by bylaw, impose upon its members such assessments as, after consultation with self-regulatory organizations, SIPC may deem necessary and appropriate to establish and maintain the fund and to repay any borrowings by SIPC. Any assessments so made shall be in conformity with contractual obligations made by SIPC in connection with any borrowing incurred by SIPC. Subject to paragraph (3) and subsection (d)(1)(A) of this section, any such assessment upon the members, or any one or more classes thereof, may, in whole or in part, be based upon or measured by (A) the amount of their gross revenues from the securities business, or (B) all or any of the following factors: the amount or composition of their gross revenues from the securities business, the number or dollar volume of transactions effected by them, the number of customer accounts maintained by them or the amounts of cash and securities in such accounts, their net capital, the nature of their activities (whether in the securities business or otherwise) and the consequent risks, or other relevant factors.

(d) REQUIREMENTS RESPECTING ASSESSMENTS AND LINES OF CREDIT

(1) ASSESSMENTS

(A) *½ of 1 percent assessment*

Subject to subsection (c)(3) of this section, SIPC shall impose upon each of its members an assessment at a rate of not less than one-half of 1 per centum per annum of the gross revenues from the securities business of such member—

(i) until the balance of the fund aggregates not less than $150,000,000 (or such other amount as the Commission may determine in the public interest),

(ii) during any period when there is outstanding borrowing by SIPC pursuant to subsection (f) or subsection (g) of this section, and

(iii) whenever the balance of the fund (exclusive of confirmed lines of credit) is below $100,000,000 (or such other amount as the Commission may determine in the public interest).

Exhibit A

Selected Parts of SIPA Section 78ddd. SIPC Fund

(continued)

(B) *¼ of 1 percent assessment*

During any period during which—

(i) the balance of the fund (exclusive of confirmed lines of credit) aggregates less than $150,000,000 (or such other amount as the Commission has determined under paragraph (2)(B)), *or*

(ii) SIPC is required under paragraph (2)(B) to phase out of the fund all confirmed lines of credit,

SIPC shall endeavor to make assessments in such a manner that the aggregate assessments payable by its members during such period shall not be less than one-fourth of 1 per centum per annum of the aggregate gross revenues from the securities business for such members during such period.

(C) *Minimum assessment*

The minimum assessment imposed upon each member of SIPC shall be $25 per annum through the year ending December 31, 1979, and thereafter shall be the amount from time to time set by SIPC bylaw, but in no event shall the minimum assessment be greater than $150 per annum.

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF COLORADO IN BANKRUPTCY

In re:

THE INVESTMENT BANKERS, INC.

Debtor.
JAMES H. TURNER, SIPC, TRUSTEE

vs.

DAVIS, GILLENWATER & LYNCH and
GILBERT K. DAVIS, individually
and as partner of DAVIS,
GILLENWATER & LYNCH, and
O'CONNOR & HANNAN, a partnership

Defendants.

FILED
UNITED STATES [illegible] COURT
COLORADO
DEC 19 1985
[illegible] Clerk
.... DEPUTY CLERK

JUDGMENT

Pursuant to and in accordance with the Memorandum Opinion entered on December 10, 1985 by the Honorable Jay L. Gueck, Bankruptcy Judge, it is

ORDERED and ADJUDGED that bankruptcy judges are without authority to decide SIPA matters, this matter will be and is dismissed.

Dated: December 9, 1985.

FOR THE COURT:

Susan Crary
Deputy Clerk

APPROVED AS TO FORM:

Bankruptcy Judge

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO IN BANKRUPTCY

In re

THE INVESTMENT BANKERS, INC.

Debtor.

JAMES H. TURNER, SIPC, TRUSTEE

vs.

DAVIS, GILLENWATER & LYNCH and
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and as partner of DAVIS,
GILLENWATER & LYNCH, and
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Defendants.

Adversary No. 82 M 87

FILED
U[illegible] BANKRUPTCY COURT
COLORADO
DEC 10 1985
[illegible]LTON, Clerk
.... DEPUTY CLERK

MEMORANDUM OPINION

THIS MATTER is before the court as a result of a complaint filed by the trustee for the debtor, Investment Bankers, Inc. ("IBI"), a securities broker dealer. The complaint seeks to avoid certain payments made by IBI to Davis, Gillenwater and Lynch ("Davis, Gillenwater), to Gilbert K. Davis ("Davis"), and to O'Connor and Hannan. The basis upon which the avoidance action is sought is 11 U.S.C. §§547 and 548. It is also alleged that certain payments which were made to the defendants were for services which were not approved, as required by §327, and that the requirements of §329 were not followed by the defendants. Thus, the trustee alleges all payments to defendants are subject to avoidance. Jurisdiction, as alleged in the complaint which was filed on January 19, 1982, was predicated upon 28 U.S.C. §1471 and 15 U.S.C. §78fff(b). Under §78eee(b)(4) of the Securities Investor Protection Act (SIPA), the entire liquidation proceeding was removed to this court after the trustee was appointed by the United States District Court, pursuant to an application submitted to that court under the SIPA.

Trial of this matter was commenced on August 7, 1984 and continued for a period of three days but was not completed. Thus, it was resumed in July, 1985 and was completed on July 19, 1985. I have considered the testimony presented in the trial, as well as deposition evidence and exhibits which have been submitted. The trustee interposed certain objections to deposition evidence, which objections are overruled. Thus, the designation of depositions submitted by the trustee has likewise been considered. I have also read the various briefs filed by the parties, both during and following trial, with the last such brief having been filed on August 16, 1985.

BACKGROUND

IBI, a Colorado corporation, acted as a securities broker dealer since October 23, 1980. A liquidation proceeding was commenced against the debtor (IBI) by the Securities Investor Protection Corporation (SIPC), pursuant to authority granted to SIPC in the Securities Investor Protection Act, 15 U.S.C. §78 aaa, *et seq*. (SIPA). The proceeding seeking liquidation of IBI was commenced on or about July 10, 1981. On July 15, 1981 the SIPA application for a liquidation order was confessed in the United States District Court for the District of Colorado, and the court appointed James H. Turner as trustee for liquidation of IBI.

On July 10, 1981, in addition to the application of SIPC for the appointment of a temporary receiver and permanent trustee to liquidate IBI, the Securities and Exchange Commission (SEC) filed a manipulation case in the United States District Court, seeking a preliminary and permanent injunction against the Company and two of its principals, Richard A. Belknap and William Gene Chandler. Belknap was the president and a director of IBI. Chandler was the office manager and a director of IBI.

The injunction sought to prevent the defendants from effecting transactions or inducing the purchase or sale of securities while IBI was in violation of "net capital" requirements provided for in the Securities Exchange Act of 1934 and Rule 17 CFR 240.15C3-1. The application for appointment of a receiver and trustee for the purpose of liquidating IBI was based upon the SIPC's determination that IBI had failed to meet its obligations to customers imposed by the SIPA and that grounds existed, specifically noncompliance with the net capital rule, for the court to issue orders for the protection of customers of IBI.

In the order of July 15, 1981 appointing Turner as trustee, the liquidation proceeding was removed to the United States Bankruptcy Court for the District of Colorado, pursuant to §5(b)(4) of SIPA, 15 U.S.C. §78eee(b)(4) (Supp. 1979). IBI consented to the order of July 15, 1981 with O'Connor and and Hannan executing the consent order as counsel for defendant IBI.

Subsequently, on July 20, 1981, the matter of the SEC's application for preliminary injunction, application for permanent injunction, and complaint on manipulation of the market came on for hearing, at which time the SEC withdrew its claim for injunctive relief against IBI in light of the appointment of a SIPC trustee and the pending liquidation of IBI. The other two defendants, Belknap and Chandler, stipulated to a court order restricting them from violating of the securities laws and from engaging in the securities business. That stipulated order was approved as to form by Gregory A. Kearns, of O'Connor and Hannan and by Gilbert K. of Davis, Davis, Gillenwater & Lynch, both of which attorneys were representing the defendants Belknap and Chandler.

After removal of the proceeding to the bankruptcy court, Turner filed a complaint seeking to avoid the transfer of four checks totaling $87,517.80 which had been executed and transferred to the defendants in this adversary proceeding on July 10, 1981. Those four separate checks are as follows:

(a) Check #13417, dated July 10, 1981, payable to Gilbert K. Davis, Esquire, in the amount of $11,858.00;

(b) Check #13418, dated July 10, 1981, payable to O'Connor & Hannan, in the amount of $25,659.80;

(c) Check #13419, dated July 10, 1981, payable to O'Connor & Hannan Trust Account in the amount of $25,000.00;

(d) Check #13432, dated July 10, 1981, payable to Gilbert K. Davis, Esquire, of Davis, Gillenwater & Lynch, in the amount of $25,000.

FINDINGS OF FACT

The facts relevant to a resolution of the issues in this adversary proceeding are as follows:

On May 8, 1981, IBI became the principal underwriter of twenty million shares of Chipola Oil Corporation (Chipola), common stock. The stock opened on the market at ten cents per share. From that time forward, the price rose slightly until, by about June 19, 1981, the price had been at a level of nineteen cents per share for approximately five weeks.

On June 19, 1981, the price began to rise dramatically, hitting fifty cents on June 26, 1981, sixty-five cents on June 30, 1981 and a dollar on July 1, 1981. During this period of time, there were approximately nineteen other market makers of

Chipola stock. The rise in price was the result "up-ticking" by IBI and other market makers. However, the evidence is clear that IBI was the primary underwriter responsible for up-ticking.[1]

This dramatic price escalation caused the SEC to investigate the possibility that the market was being manipulated, with the result that on July 2, 1981 the SEC delivered a letter to IBI advising that the SEC suspended trading in Chipola for a period of ten days, as of 7:45 a.m. on that date. This resulted in no further market being available for the sale of Chipola stock, with the result that its value was deemed to be zero at that point. Following the SEC investigation, IBI was admonished of the necessity to comply with the Commission's net capital rule and to notify the SEC by telegram if IBI was not in compliance. Later that same morning, IBI sent a telegram advising the SEC that IBI would cease operations until its net capital complied with Rule 13-C31 of the SEC.

The SEC and the NASD immediately dispatched investigators to the office of IBI to examine the books and records of the company in an effort to ascertain its true financial status. Most of this was in the presence of Gregory A. Kearns, a partner in O'Connor & Hannan, who had represented IBI since 1980.

The investigation was primarily conducted by Jackson Arthur Woodruff, Jr., an NASD examiner. His efforts revealed that, as of July 10, 1981, IBI had a negative net worth of $7,084,417.31, with total liabilities of $9,184,237.52. Thus, total assets were valued at $2,099,820.21. However, this computation was based upon valuing Chipola stock at zero.

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[1] "Upticking is a process of buying stock from other broker dealers under circumstances resulting in a price escalation. Thus, as additional shares are acquired, the market in the stock is "upticked". The purpose of such a practice is to force short sellers (i.e. those who sell more stock than they have available for sale) to pay a higher price for stock necessary to cover the sales they have made. The term "cover their shorts" means to cover short sales, while the term "squeeze their shorts" is used to describe the process of forcing a short seller to cover.

Chipola was set at zero because trading had been suspended by the SEC on July 2, 1981, which left no ready market for the stock. According to the net capital rule, if there is no ready market for a stock, it must be valued at zero in determining compliance with the net capital rule. Of the twenty million shares brought public, IBI had 14,663,157 shares in its inventory on July 10, 1981. On June 30, 1981, approximately nine to ten million shares were in inventory.

Valuing Chipola at zero, IBI was required to have $758,611.35 net capital on July 10, 1981. The net capital deficiency was $8,103,210.61. On this basis,it was determined that IBI would be required to place $4,423,002.44 into a special reserve account for the protection of its customers.

It is interesting to observe that all of these figures and requirements are predicated upon a system whereby the SEC can suspend trading for the investigation of a violation of the net capital rule, thus creating a situation where there is no ready market. Since there is no ready market, paragraph 15-c3-1 of the net capital rule requires that the stock be valued at zero. This, then, is of great aid to the SEC in supporting it contention that the organization under investigation is in violation of the net capital rule. On this basis, the SEC then continues the suspension in trading until any net capital deficiencies it has declared to exist by virtue of its own creation of "no ready market" is replenished from other sources. This manipulative practice has apparently received the sanction of the courts and the Congress over the years. Aside from investigations of net capital violations, the NASD normally honors a stock's value as reflected on the firm's books.

Computations were also made by Mr. Woodruff, valuing Chipola at nineteen cents. Utilizing this valuation, as of July 10, 1981, IBI was still left with a negative net worth of $4,298,418.62. Its net capital was negative $5,451,489.05, with a net capital deficiency of $6,210,100.40.

At trial, values were also determined as of June 30, 1981. Using a valuation of Chipola at nineteen cents per share, it was determined that, as of June 30, 1981, IBI had assets of $1,650,090.14 and liabilities of $1,316,093.30, reflecting a positive net worth of $333,936.84. This left IBI with a positive net capital of $76,884.13. However, it still left a net capital deficiency of $86,056.76. It also used the number of nine million to ten million shares in inventory, as of June 30, 1981.

Finally, computations were made at a figure of $.65625, apparently as of June 30, 1981. The closing bid price on Chipola stock on June 30, 1981 was $.65625. This reflected liabilities of $1,316,093.30, with assets of $2,506,707.95. Thus, a net worth existed in the amount of $1,190,614.65 and a positive net capital of $511,302.72.

All of Mr. Woodruff's computations involved "haircuts" (i.e., arbitrary deductions for safe, conservative figures). These haircuts varied in the amount of deductions from $109,192.79 to $366,178.13, depending upon whether nineteen cents or $.65625 was used. The net worth figures were also manipulated by Mr. Woodruff by deducting various "nonallowable" items as reflected on the books and records of the company.

Other values, involving different assumptions, were also the subject of testimony at trial. Two other expert witnesses were presented by the trustee in support of his contention that IBI was insolvent at the time the checks were negotiated to these defendants. One witness, Mr. Tom Kundinger, was a partner in the CPA firm of Peat, Marwick & Mitchell. The second was Mr. Roy Sandberg, a branch manager of Engler and Budd, a securities broker/dealer. The testimony of each of these witnesses would support the proposition that the sum of IBI's debts on July 10, 1981 was greater than the fair valuation of its property. However, it must be observed that Mr. Sandberg, for whatever reason, could not come to grips with what was meant by "market value", "true value", or "fair value." He assigned a value to Chipola stock of $0.055, although as a trader he had paid sixty-five to seventy cents per share for it. This witness' testimony was of little help. My findings are primarily based upon the analysis conducted by Mr. Woodruff.

On July 8, 1981, Gilbert K. Davis was contacted by James Prude, a sales manager and registered representative of IBI, to represent the debtor and two of its officers, Belknap and Chandler, in matters before the SEC and in matters relating to the suspension of trading. Davis was not at any time retained to perform any work in the bankruptcy field. Davis went to Denver from Virginia, along with two other attorneys. The first was Frank Vecchio, an SEC attorney from Michigan, and the second was an attorney from Gnau, Carter & Jacobsen, a Washington political consulting firm.

A fee of $10,000 was arranged, to be divided among the three attorneys. Conferences were held on July 8 through 10, 1981. The evidence indicates the parties and these attorneys were aware during the entire course of Davis' representation, of at least the possibility that the SEC would file a liquidation proceeding and seek injunctive relief against IBI in the United States District Court.

A retainer was agreed upon for further work, in the amount of $25,000. This fee included Davis' appearance at the hearing of July 10, 1981 on the SEC's application for injunction and the SIPC's action to liquidate IBI.

The evidence establishes that Davis received checks numbered 13417 and 13432 at about noon on July 10, 1981. These were promptly cashed into cashier's checks at the First National Bank of Denver. This transaction occurred at approximately 2:51 p.m. Davis claims to have learned of the SEC action which was to be taken that afternoon sometime subsequent to cashing these checks.

The O'Connor and Hannan checks were received at approximately 10:00 a.m. on July 10, 1984 and were cashed within one to one and one-half hours thereafter. One of the reasons these checks were taken to the bank immediately was due to the fact that O'Connor and Hannan had previously experienced an insufficient funds check from IBI. One of the checks, number 13418, was given to O'Connor and Hannan for previously rendered legal services. O'Connor and Hannan had represented IBI since 1980. IBI owed for prior legal services for the month of June 1981, as well as earlier months. Of the total amount of $25,659.80 reflected in check number 13418, the sum of $8,146.25 was attributable to legal services rendered in June of 1981, together with costs incurred in the amount of $71.30. The amount of $17,441.78 was attributable to legal services rendered in months prior to June 1981. This included $4,697.50 in legal fees, and costs of $1,879.65, in May, 1981; legal fees of $5,131.25 and costs of $874.67 in April, 1981; and legal fees of $5,652.50, together with costs of $359.58 incurred in March, 1981. There were consistently balances due and owing on each monthly statement for several months prior to July 10, 1981. During this same period of time, IBI paid $10,000 on account in March and May, 1981. Check number 13419 was then paid to O'Connor and Hannan as a retainer "for legal services to be performed in connection with the trading suspension of Chipola" stock. These services appear to have been performed by O'Connor and Hannan from and after approximately July 1, 1981, and such time was ultimately credited against the retainer amount or was partially included in the July 10, 1981 billing.

Check number 13417 was paid to Gilbert Davis in the amount of $11,858.00. This was to cover consulting fees by Davis and others, all relating to the SEC investigation. The $25,000 check reflected in number 13432 was paid to Davis, Gillenwater and Lynch as a retainer in connection with the suspension of Chipola stock and all other matters relating to the SEC investigation, "including involvement of NASD and/or SIPC."

At the hearing on July 10, 1981, Davis, along with O'Connor and Hannan, entered an appearance for the defendants IBI, Belknap and Chandler. That hearing resulted in the consent order, whereby IBI would not engage in any business whatsoever, other than the payment of rent, utilities and salaries of existing employees. The business to be terminated included, but was not limited to the following: "no disbursement of any funds, no transfer or disbursement of assets, no incurring of any liabilities, no transactions in securities and no settlement of any transactions."

On July 14, 1981, the SEC renewed its application for a preliminary injunction and request for the appointment of receiver. One of the grounds upon which this application was based was the issuance of the four checks, as well as other checks, on July 10 through 13, 1981. It was contended by the SEC that the issuance of these checks was contrary to representations made by counsel for IBI at the July 10, 1981 hearing. It is clear that no evidence of those four checks was ever revealed to the SEC during the July 10, 1981 hearing or prior thereto.

Thereafter, the previously mentioned hearings of July 15, 1981 and July 20, 1981 took place.

CONCLUSIONS OF LAW

Several jurisdictional challenges have been interposed, seeking to prevent this court from exercising authority over the issues presented in this proceeding.

First, it is contended that the authority of bankruptcy judges ended on June 27, 1984, and that the retroactive provisions enacted by Congress in the bankruptcy amendments and Federal judgeship act of 1984 attempting to continue the terms of bankruptcy judges was in controvention of Article II, §2 of the U.S. Constitution ("the Appointments Clause"). Secondly, the defendants allege that the bankruptcy amendments and Federal Judgeship Act of 1984, in enacting 28 U.S.C. §157, did not provide for the reference of matters brought under the Securities Investment Protection Act, 15 U.S.C. §78(aaa), et seq., from the U. S. District Courts to United States Bankruptcy Judges. Thirdly, defendants argue that SIPC trustees have no authority to pursue fraudulent transfers under 11 U.S.C. §548, since they have not been delegated that authority in the SIPA. Finally, it is argued that bankruptcy judges do not have jurisdiction to hear claims for preferences, In Re United Groceries of Nebraska Cooperative Inc., 46 B.R. 173 (Bankr. Neb. 1985) in support of this proposition.

I. Were the terms of bankruptcy judges constitutionally extended so as to continue to confer authority in the bankruptcy court?

The complaint in this adversary was filed on January 19, 1982. The matter came on for trial in August 1984, but was bifurcated and not completed until July 19, 1985.

The Bankruptcy Amendments and Federal Judgeship Act of 1984 (BAFJA) was enacted on July 10, 1984. The transition period setforth in the bankruptcy act of 1978 was set to expire on March 31, 1984. Congress extended the transition on four separate occasions through a series of interim measures, with the final extension providing for the terms of office of bankruptcy judges to expire on June 27, 1984. P.L. 98-249, 98 stat. 116 [March 31, 1984], P.L. 98-271, 98 stat. 163 [April 30, 1984], P.L. 98-299, 98 stat. 214 [May 25, 1984], and P.L. 98325, 98 stat. 268 [June 20, 1984]. However, it must be noted that the "holdover provisions" of §§ 404(b)(d), of the Bankruptcy Reform Act of 1978, P.L. 95-598, 92 stat. 268384 (1978) were in effect until enactment of the BAFJA of 1984. Section 404(b) provided:

> The term of a referee in bankruptcy who is serving on the date of an enactment of this [Bankruptcy Reform Act of 1978] is extended to and expires on March 31, 1984 or when his successor takes office (emphasis supplied).

The BAFJA purported to extend bankruptcy judges' terms of office from June 27, 1984 to the date of an enactment of the act, by virtue of §121(e) of that act. Then, in §106(a), it was provided as follows:

> ...the term of office of a bankruptcy judge who is serving on the date of an enactment of this Act is extended to and expires four years after the date such bankruptcy judge was last appointed to such office or on October 1, 1986, whichever is later.

The foregoing difficulties in resolving the authority and jurisdiction of bankruptcy courts has given rise to many challenges to the validity to the entire bankruptcy court system, including the contention that §121(e) attempts unconstitutionally and retroactively to create congressionally appointed bankruptcy judges in violation of the appointments clause of the Constitution of the United States, as reflected in our Article II, §2 of the Constitution.

The various courts who have considered this issue have uniformly rejected similar challenges to the authority of bankruptcy judges. In the Matter of Balwin United Corporation, 48 B.R. 49 (Bankr. S.D. Oh., W.D. 1985); In Re Tom Carter Enterprises, 44 B.R. 605 (Bankr. D.C. C.D. Cal. 1984); In Re Benny, 44 B.R. 581 (Bankr. D.C. N.D. Cal. 1984); In Re Wasatch Factory Inc., Miscellaneous B-0015W (D. Utah November 26, 1984); In Re Shearn Moody, Jr., Case No. M-84-90; B-8301490C-11 (D. Ct. Middle District N.C. 1985).

I see no reason from the arguments presented before me to deviate from the reasoned opinions set forth in these decisions. Therefore, the objection to the bankruptcy court's authority as a violation of the appointments clause of the United States Constitution is overruled.

II. Does the bankruptcy court have authority or jurisdiction to resolve disputes under the SIPA?

Defendants contend that in adopting the BAFJA of 1984, Congress neglected to provide for the referral of SIPA matters from the United States District Courts to the bankruptcy courts. This is, indeed, a troublesome contention.

As a part of the BAFJA of 1984, Congress enacted 28 U.S.C. §157 to provide a procedure for referral of bankruptcy cases and proceedings from the district courts to the bankruptcy judges for the district. Section 157 provides as follows:

> (a) Each district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district.
>
> (b)(1) Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11, referred under subsection (a) of this section, and may enter appropriate orders and judgments, subject to review under §158 of this title.

SIPA matters are not "cases under title 11" and are not proceedings "arising under" or "arising in or related to a case" under title 11. SIPA matters arise under the Securities Investor Protection Act, 15 U.S.C. §78aaa, et seq. It can readily be seen that the Securities Investor Protection Act is not a title 11 matter. It is a title 15 matter. Further, I can not construe title 15 matters to be "related to" title 11 cases. I know of no decisions finding that SIPA matters are proceedings arising under, arising in or related to title 11 cases. They have customarily been referred to referees in bankruptcy, and since 1978 referred to bankruptcy judges. The bankruptcy Reform Act of 1978 made certain amendments to conform salient portions of SIPA to the Bankruptcy Code. Section 78eee (b)(4) of SIPA provides:

> (4) REMOVAL TO BANKRUPTCY COURT
> Upon the issuance of a protective decree and appointment of a trustee, or a trustee and counsel, under this section, the court shall forthwith order the removal of the entire liquidation proceeding to the court of the United States in the same judicial district having jurisdiction over cases under title 11. The latter court shall thereupon have all of the jurisdiction, powers, and duties conferred by this chapter upon the court to which application for the issuance of the protective decree was made.

The BAFJA of 1984 was enacted only after great debate covering a period of two years. In that act, the Congress chose to repose jurisdiction over title 11 matters in the United States District Courts. Thus, the district court is now "the court."

There has been no legislative action to invest bankruptcy judges with any jurisdiction ove SIPA matters. The reference authority set forth in 28 U.S.C. §157 and that created by virtue of general procedure order number 1984-3 in this district only refer title 11 matters to bankruptcy judges.

The SIPC concedes that aliteral construction of §78eee(b)(4) of the SIPA and §157 of the BAFJA must necessarily result in depriving bankruptcy judges of any authority or jurisdiction to decide anything under a SIPA proceeding. There is simply no presently existing statutory authority for removal of a SIPA case from the district court to a bankruptcy judge. Nonetheless, the SIPC argues that Congress' clear intent has long been to require that all matters in a SIPA case be determined by the bankruptcy courts. Citing much legislative history, the SIPC then urges that the bankruptcy court has jurisdiction under SIPA. It is further asserted that a literal interpretation of present statutes would result in an absurdity of requiring district courts to "remove" SIPA cases to themselves. "All laws are to be given a sensible construction. A literal application of a statute which would lead to absurd consequences is to be avoided whenever a reasonable application can be given which is consistent with the legislative." *United States v. Ryan*, 284 U.S. 167 76 L. Ed. 224, 52 S. Ct. 65. (1931).

There are several difficulties with the proposition advanced by SIPC. First, it must be observed that much of what Congress promulgated in the 1984 BAFJA results in absurdity. This is but one example. To uphold the SIPC's line of reasoning on this issue would result in conferring jurisdiction in the bankruptcy judges over title 15 matters by way of removal "to the court of United States...having jurisdiction over cases under title 11" when bankruptcy judges do not even have jurisdiction over the cases under title 11." *See*, *In Re Herrara*, *supra*. This, to, is an absurd result.

Further, resorting to legislative history is only appropriate where the language of a statute is ambiguous. *In Re Galvan*, 39 B.R. 663 (D.C. Colo. 1984). Where the language of a statute is clear, use of committee reports, legislative comments, and the like is unnecessary. *Id.*, at page 665. "It is presumed that when Congress drafts a statute it does so with full knowledge of the existing law;..." *Id.*, at 665. There is no ambiguity in any of the language of statutes under consideration here. Clearly, only title 11 cases and matters relating to, or arising in or out of title 11 cases may be referred to bankruptcy judges under legislation promulgated by the Congress. Had Congress desired to include title 15 matters

in the legislative reference allowance, it only needed to include a sentence in 28 U.S.C. §157 so providing. Congress had two years leading up to promulgation of the BAFJA, and it has now had an additional year since that time. No changes have been made.

I know of no authority giving the court the power to second guess what Congress might, or should have done, simply because a judge thinks it should have been so. Perhaps Congress did not want bankruptcy judges to assume responsibility of over SIPA matters, and merely failed to conform the SIPA to the 1984 BAFJA. This is at least as plausible an explanation as to assume Congress forgot to include a SIPA reference provision in BAFJA.

In the absence of legislation conferring jurisdiction on bankruptcy judges over SIPA matters or a reference from the district court authorizing bankruptcy judges to exercise the district court jurisdiction, bankruptcy judges are without authority over non-title 11 matters.

SIPC also contends that SIPA matters are really "core" proceedings arising directly out of §§327, 329, 547, and 548 of title 11. No authority is cited for this contention. I have found none. It is true the powers of a SIPA trustee include those possessed by a trustee in a case under title 11. 15 U.S.C. §78fff-1(a). These include many core matters under the bankruptcy code. However, the powers of the trustee is a separate consideration from determining what court shall exercise jurisdiction over a SIPA liquidation proceeding. Thus, I can not conclude that a SIPA liquidation proceeding under title 15 of the U.S. Code is nothing more than a core proceeding under 28 U.S.C. §157.

Based upon the foregoing discussion and authority, I would conclude that bankruptcy judges are without jurisdiction or authority to rule on the matters presently before me. However, recognising that legal analysis and authority has previously been strained and stretched to save the bankruptcy court system where Congress has failed to act, it is possible that, on appeal, analysis by an appellate court may create authority where I have found none to exist. Therefore, I shall proceed to a resolution of other issues in the event the requisite authority is provided on appeal.

III. *Does the bankruptcy court have jurisdiction or authority to resolve 11 U.S.C. §§ 547 or 548 matters in a SIPA proceeding?*

The defendants contend that a SIPA trustee does not have authority to bring actions seeking to avoid transfers under 11 U.S.C. §§ 547 or 548. The primary authority upon which defendants rely on support of their §547 argument is *In Re Associated Groceries of Nebraska Cooperative, Inc*., *supra*. (Bankr. Neb. 1985). In support of their position that a SIPA trustee lacks authority to bring an action under §548, defendants point out that the purposes of a "liquidation proceeding" under SIPA are enumerated in 15 U.S.C. §7°fff(a), and that these purposes do not include fraudulent transfer action sunder 11 U.S.C. §548. Defendants cite 15 U.S.C. §78 fff1(a), which provides, in part:

> A trustee shall be vested with the same powers and title with respect to the debtor and the property of the debtor, including the same rights to avoid preferences, as a trustee in a case under title 11.

As can be seen from the foregoing, no mention is made of fraudulent transfers. Thus, we are faced with another resolution of what authority Congress intended to confer.

With respect to the authority of a SIPA trustee to pursue a §547 preference action, the bankruptcy court *In Re Associated Groceries of Nebraska Cooperatives, Inc.*, *supra*, held that a preference determination between the debtor and the defendant involves the adjudication of purely private rights which, absent consent of the parties, must be tried to an Article III court under *Northern Pipeline Construction Co., v. Marathon Pipeline Co.*, 458 U.S. 50, 102 S. Ct. 2858, 73 L.Ed. 2d 598 (1982). A motion to dismiss a preference action under §547 of the Code was granted, inspite of the clear listing of such an action as a core proceeding under 28 U. S. C. §157(b)(2)(F). It was determine that the bankruptcy court had no jurisdiction over the matter. There was no discussion of the authority of the bankruptcy court to administer the matter as a related proceeding, submitting proposed findings of fact and conclusions of law to the district court.

I know of know other decisions following *In Re Associated Groceries of Nebraska Cooperatives, Inc.*. I do not believe the Supreme Court of the United States intended to go that far, and I decline to follow Associated Groceries.

With respect to the authority of a SIPA trustee to pursue fraudulent transfers under 11 U.S.C. §548, there is a ample authority in support of such an action. *Securities Investor Protection Corporation v. S.J. Salmon & Co. Inc.*, Case No. 72 Civ. 560 (S.D. N.Y. 1973); 3 *Collier on Bankruptcy*, paragraph 60.65 at page 1246 (14th Ed. 1977).

Such actions by SIPA trustees seeking to recover estate property routinely have been brought, both under the bankruptcy code of 1978 and the earlier bankruptcy act. *See*, *e.g.*, *In Re Bell & Beckwith* 44 B.R. 656 (Bankr. N.D. Oh. 1984); *Klein v.*

Tabatchnik, 418 F. Supp. 1368 (D.C. S.D. N.Y. 1976), aff'd in part and reversed in part on other grounds, 610 F. 2d 1043 (2d Cir. 1979). I can find no provisions in the BAFJA or the SIPA which would case me to feel the results should be other wise at this time. Thus, I conclude that the trustee does have authority to pursue preference actions under §547 as well as fraudulent transfers under §548 of the Bankruptcy Code.

Other challenges to the authority of this court or the authority of the trustee I conclude to be without merit.

SUBSTANTIVE ISSUES

I. Has there been a voidable preference under 11 U.S.C. §547?

Under §547 of the Code, a preference can be avoided where there has been a transfer of property, on or within ninety days prior to filing a petition under title 11, to a creditor on an account of antecedent debt, owed by the debtor before such transfer was made, while the debtor was insolvent, which enables such creditor to receive more than he would have received had the transfer not been made. There is a presumption under §547(f) that the debtor is insolvent on and during the ninety days immediately preceding the date the petition is filed.

The liquidation petition was filed on July 10, 1981. The disputed checks were transferred and cashed on that same day, just shortly prior to filing the petition. It is the trustee's contention that check number 13418 in the amount of $25,659.80 to O'Connor and Hannan and check number 13417 in the amount of $11,858 to Davis constitute voidable preferences under §547 of the Code.

In addition to vigorously contesting the issue of insolvency, the defendants postulate certain affirmative defenses. Under these affirmative defenses, defendants argue that they fall under the exemptions provided by §547(c)(1) as a contemporaneous exchange for new value, and that the payments made to them were made in the ordinary course of business as provided in §547(c)(2).

A. Payment to O'Connor and Hannan

It is clear that the payment of $25,659.80 represented in check number 13418 to O'Connor and Hannan was for an antecedent debt. The real disputes centers around whether the debtor was insolvent at the time the transfer was made.

In addition to the presumption of insolvency, there was ample evidence presented by the trustee indicating insolvency on July 10, 1981. I could not conclude that any amount in excess of nineteen cents could legitimately be used to determine the value of Chipola stock as of July 10, 1981. The evidence convinces me that any amount beyond nineteen cents was the result of manipulative procedures by the principals of IBI. I also conclude that valuing Chipola stock at zero is the result of manipulation by the government. Thus, such a valuation would likewise be unfair. The values which were the subject of testimony by Messers. Sandberg and Kundinger are not persuasive.

Valuing Chipola stock at nineteen cents per share, on July 10, 1981 IBI was insolvent.

The final question to be examined, prior to reviewing the exceptions to §547, is whether the creditor received more than it would have received if the case were a case under Chapter 7, the transfer had not been made and the creditor had received payment to the extent provided by the provisions of the Code. Here it becomes necessary to examine the right of O'Connor and Hannan to receive payment on these fees in light of §329 of the Code.

The services rendered which are represented by check number 13418 were for legal services rendered prior to and not in contemplation of or in connection with the SIPA action. They were also subject to a valid attorneys' lien, as provided in C.R.S. §12-5-119 (1973). Such a lien is a statutory lien and not a judicial lien. Thus, the lien is not avoidable under 11 U.S.C. §522(f).

A creditor who receives payment on a secured claim has not been preferred simply because he realizes the value of his collateral earlier than if he had waited until liquidation. Such payments do not deplete the debtor's estate, and thereby deprive other creditors of their rights to payment from the estate. In Re Hawkins Manufacturing Inc., 11 B.R. 512 (Bankr. Colo. 1981).

O'Connor and Hannan also contend that they fall within one of the exceptions provided in §547(c)(1) or (2). Payment is, of course, insulated from attack as a preference if the creditor establishes that he comes within one of these exceptions. In Re Auto Train Corporation, 49 B.R. 605 (D.C. 1985); In the matter of Advance Glove Manufacturing Co., 42 B.R. 489 (Bankr. Ed. Mich. S.D. 1984).

I conclude that the payment here involved does not fall within the exception of §547(c)(1) as a contemporaneous exchange for new value. The contention is made by the trustee that since trading had been suspended and IBI was doing no business on July 10, 1981, the payment could not have been made in the ordinary course of business, as contemplated in §547(c)(2).

However, the suspension in trading on July 2, 1981, did not mean that IBI could not conduct any business whatsoever, such as paying its bills and employees; nor did such suspension in trading nullify debts previously incurred by IBI and the ordinary course of business. I conclude, from the evidence before me, that the payment of check number 13418 to O'Connor and Hannan was, indeed, in payment of a debt incurred by IBI in the ordinary course of its business, was made in the ordinary course of the business and financial affairs of IBI and O'Connor and Hannan, and was made according to ordinary business terms. The fact that O'Connor and Hannan took the unusual step of immediately cashing this particular check does not detract from this result.

II. Payment to Davis of check number 13417 in the amount of $11,858

The law previously discussed as applicable to the payment to O'Connor and Hannan is likewise applicable to Davis. However, there are certain factual differences which make the result different.

The extension of credit in Davis' case was for only a few days. Nonetheless, this constituted an antecedent debt, no matter how brief the extension of credit. Enegelkes v. Farmers Cooperative Co., 194 F. Supp. 319 (N.D. Iowa 1961). Services render were for the period of time spanning July 8, 9, and the morning of July 10, 1981.

The evidence convinces me that all of the services rendered by Davis and by Davis, Gillenwater & Lynch were in contemplation of or in connection with the SIPA case and its anticipated filing. Accordingly, §329 of the Code is applicable, and Davis has failed to establish compliance with that section. This destroys any possible exception to avoidance under §547(c)(2). Further, most, if not all, of the representation provided by Davis and Davis, Gillenwater & Lynch was for individuals and not for IBI.

I conclude this payment is subject to avoidance as a preference.

IV. Were the transactions herein inolved voidable as fraudulent conveyances underll U.S.C. §548?

The trustee seeks to set aside and have returned to the estate the $25,000 retainer paid to O'Connor and Hannan in check number 13419 and the $25,000 retainer paid to Davis, Gillenwater & Lynch represented by check number 13432. The trustee contends that these payments constituted fraudulent transfers under 11 U.S.C. §548.

The Bankruptcy Code provides two definitions of fraudulent transfers under §548. The first requires a showing that the transfer was made with actual intent to hinder, delay or defraud creditors. The second, an alternative definition, is that the debtor received less than a reasonably equivalent value in exchange for the transfer at a time when the debtor was insolvent or was engaged in business or about to engage in business for which any property remaining constituted an unreasonably small capitol, or intended to or believed it would incur debts beyond its ability to pay as such debts matured. The trustee primarily relies upon the second definition.

In proceedings under §548 of the Code, the burden of proof is on the trustee to establish the fraudulent conveyance. In Re Ears, Nose & Throat Surgeons of Worcester, Inc., 49 B.R. 316 (Bankr. Mass. 1985); 4 Collier on Bankruptcy, §548.10 at page 548-111, 112 (15th Ed. 1985).

To set aside a transfer under §548(a)(2), four elements must be established. It must be shown that 1) there was a transfer of an interest of the debtor and property, 2) which occurred within one year of the filing of bankruptcy, 3) that the debtor received less than a reasonably equivalent value and exchange for this transfer, and 4) that the debtor was insolvent on the date of the transfer, became insolvent as a result, or was left with an unreasonably small capitol. In Re Ear, Nose & Throat Surgeons of Worcester, Inc., supra; In the Matter of Curtina International Inc., 23 B.R. 969 (Bankr. S.D. N.Y. 1982).

Contrary to the contentions made by O'Connor and Hannan in its trial brief, there need not always be a pernicious intent, involving moral turpitude, in a fraudulent conveyance under §548. Indeed, that is not a necessary element at all under §548(a)(2).

There is no dispute that the transfers were made to Davis, and to O'Connor and Hannan within one year of filing the petition. I have already determined that IBI was insolvent on July 10, 1981, the date of the transfers. The question to be addressed is whether IBI received less than a reasonably equivalent value in exchange for the transfers represented by these retainer fees.

The question of reasonable equivalents should be determined in light of the function of §548, which is to achieve an equitable distribution of the debtor's property. In Re Richardson, 23 B.R. 434 (Bankr. Ut. 1982). What the debtor received in exchange for the retainers was the agreement of counsel to represent the debtor in the contemplated SIPA proceeding. There are several reasons why these payments are subject to avoidance under §548(a)(2). First, since the representation to be rendered was in contemplation of or in connection with the case which was filed that day, both O'Connor and Hannan and Davis, Gillenwater & Lynch needed to comply with §329 of the Bankruptcy Code. This does not appear to have been done. The lack of a statement of compensation paid, is required by §329(a), impinges upon the courts ability to pass upon the reasonableness of fees in connection with representation in the liquidation proceeding. Further, no representation of the trustee is authorized except by appointment under §327 of the Bankruptcy Code. Representation of the debtor, not as a debtor-in-possession or a trustee, need not receive the sanction of the court. However, compensation of the debtor's attorney is governed by §330 of the Code if payment is to come from funds of the estate. These avenues are still available to counsel for the debtor. However, the retainers received on July 10, 1981 short circuited the aformentioned provisions. An additional reason for disgorging the fees received by way of retainer is that at least some of the services rendered thereafter were rendered for individuals. Additionally, most of the services rendered were for the purpose of resisting the petition for a SIPC liquidation and to avoid the SECC's application for a preliminary injunction. These services are generally considered to benefit the individual principals and officers of the company. Thus, they are not compensible from the estate. Securities and Exchange Commission v. Capitol Counselors Inc., 378 F. Supp. 224 (S.D.N.Y. 1974), aff'd 512 F. 2d 654 (2d Cir. 1975); Securities and Exchange Commission v. Allen F. Hughes, Inc., 481 F. 2d 401 (2d Cir. 1973), cert. denied 414 U.S. 1092 (1973). I can not tell from the evidence what portion of the fees were attributable from individual representation and what portion would be attributable to representation of the debtor or the trustee, if such representation was authorized by the court.

I conclude that there was no reasonably equivalent value, as of July 10, 1981, given by either O'Connor and Hannan or Davis, Gillenwater & Lynch to IBI in exchange for the two retainer checks, each in the amount of $25,000.

Based upon the foregoing discussion and authority, I conclude that the retainer checks for $25,000, represented by checks numbered 13419 and 13432 should be subject to avoidance under 11 U.S.C. §548(a)(2).

Finally, I find no merit to further affirmative defenses or counterclaims alleged by the defendants.

CONCLUSION

Based upon my conclusion that bankruptcy judges are without authority to decide SIPA matters, this matter will be and is dismissed. The remainder of this opinion shall constitute the findings and conclusions of this court in the event proper authority is found to exist in the bankruptcy court. In such event, it is my conclusion that check number 13418 in the amount of $25,659.80 payable to O'Connor and Hannan is not subject to avoidance as a preferential transfer, and judgment shall enter in favor of O'Connor and Hannan on that claim. Check number 13417 in the amount of $11,858, payable to Gilbert K. Davis, is subject to avoidance as a preferential transfer. Check number 13419 in the amount of $25,000, payable to O'Connor and Hannan is subject to avoidance as a fraudulent transfer under 11 U.S.C. §548(a)(2). Check number 13432 in the amount of $25,000, payable to Davis, Gillenwater & Lynch, is subject to avoidance as a fraudulent transfer under 11 U.S.C. §548(a)(2).

IT IS SO ORDERED.

DATED: December 10, 1985.

BY THE COURT

Jay L. Gueck
JAY L. GUECK, Judge

NOTICE OF ENTRY ON DOCKET
[illegible] Pursuant to Rule 9022,
[illegible] Order of Judgment was
[illegible] 12/12/85

[Release No. 34-18262; SIPA-100]

Regulation of Broker-Dealers

AGENCY: Securities and Exchange Commission.

ACTION: Notice to Broker-Dealers Concerning Interest-Bearing Free Credit Balances.

SUMMARY: The Securities and Exchange Commission today cautioned broker-dealers against soliciting customers to deposit or leave funds with a broker-dealer for the purpose of creating or maintaining cash balances solely to earn interest. The Securities Investor Protection Act of 1970 protects "customer" claims up to $500,000 per customer, no more than $100,000 of which can be claims for cash. Protection under that Act is available for a cash balance, however, only if that balance is in an account for the purpose of purchasing securities or as a result of a sale of securities. Cash balances created or maintained solely for the purpose of earning interest are not protected under that Act. Therefore, misrepresentations by broker-dealers about the availability of protection under that Act and other misleading broker-dealer advertising, promotional or selling practices that could result in a denial of "customer" status and thus protection under that Act -- because such practices, among other things, induce investors to deposit or leave funds with a broker-dealer solely for the purpose of earning interest -- will be deemed violations of the rules of the self-regulatory organizations and the Commission. Advertisements that misrepresent the availability of protection under the Securities Investor Protection Act of 1970 also will be deemed violations of Section 15(d) of that Act.

DATE: November 17, 1981.

FOR FURTHER INFORMATION CONTACT: Harry Melamed (202/272-2897), Senior Special Counsel, or Thomas V. Sjoblom (202/272-2913), Branch Chief, Division of Market Regulation, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: Some broker-dealers currently state, in oral communications and in written advertisements, that they pay interest on customers' free credit balances. 1/ The Commission believes that the payment of interest by broker-dealers on free

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1/ Free credit balances are customers' funds held by broker-dealers that may be withdrawn by customers on demand. Usually, they are generated when (i) a customer gives cash to the broker-dealer with advice that instructions for the purchase of securities will follow; (ii) a broker-dealer receives interest or dividends on the customer's securities held in "street" name and does not immediately transmit those funds to the customer; or (iii) a broker-dealer sells a customer's securities and holds the proceeds pending reinvestment or other instruction from the customer. See SEC, Report of the Special Study of the Securities Markets, H.R.Doc. No. 95, 88th Cong., 1st Sess., pt. 1, ch. III, at 393-94 (1963). Free credit balances are liabilities owed by the broker-dealer to the customer. See 17 CFR §240.15c3-3(a)(8).

credit balances that arise as an incidence of customer securities activities is a business matter between a broker-dealer and its customer and normally will not raise regulatory concerns. 2/ When broker-dealers engage in certain advertising, promotional or selling practices to obtain these funds, however, those practices may constitute violations of the Securities Investor Protection Act of 1970 ("SIPA") and the rules of self-regulatory organizations ("SRO's") and the Commission.

I. PROTECTION OF CUSTOMER FUNDS UNDER SIPA

SIPA provides specific, limited protection to customers of broker-dealers that are forced to liquidate. Currently, the limits of protection are $500,000 per customer, no more than $100,000 of which can be claims for cash. 3/ Section 16(2) of SIPA,

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2/ The Commission also believes, however, that there may be a regulatory distinction, for purposes of application of the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940, between the conventional type of interest-bearing free credit balance that arises as an incidence of maintaining a securities account for a customer and an interest-bearing account that is, in economic reality, a separate security.

3/ See Section 9(a)(1) of SIPA, 15 U.S.C. §78fff-3(a)(1).

however, defines the term "customer" to include, among others, "any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purpose of purchasing securities . . . ." If a person is not a "customer" as that term is defined in Section 16(2) of SIPA, free credit balances will not be protected under SIPA.

For purposes of determining whether persons creating or maintaining interest-bearing free credit balances are customers under SIPA, the Securities Investor Protection Corporation ("SIPC") has adopted the following policy:

> Cash balances are protected under the Securities Investor Protection Act if the money was deposited or left in a securities account for the purpose of purchasing securities. This is true whether or not the broker pays interest on the cash balances. Of course, cash balances maintained solely for the purpose of earning interest are not protected.
>
> SIPC presumes that cash balances are left in securities accounts for the purpose of purchasing securities. It would require substantial evidence to the contrary to overcome this presumption. Standing alone, the fact that a cash balance was earning interest and was not used to purchase securities for a considerable period of time, say four or five months, would not be sufficient to overcome the presumption. 4/

4/ SIPC, Semi-Annual Report, June 30, 1981.

DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

PART II

TUESDAY, MARCH 4, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Riegle, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today we continue our oversight and overview of the deposit insurance system. The deposit insurance mechanism was created over 50 years ago to provide depository security to prevent the type of panic behavior that had frequently caused bank runs and ultimately failures.

As is obvious from earlier hearings, today deposit insurance continues to play a vital role in ensuring continued public support for our financial intermediary system. Clearly, any changes in the existing structure or function of deposit insurance resulting from these oversight hearings must and will continue to foster ongoing safety and soundness of the banking system, thus preserving the confidence of the public.

Implicit in any discussion of maintaining public confidence in our banking system as well as its continued safety and soundness is the ongoing need to reexamine the overall statutory and regulatory framework of the financial services system.

The financial services industry continues to go through a revolutionary remolding process as a result of technological and economic changes. The basic legal framework was established by Congress in the 1930's and a great deal has changed during those 50 years. Congress must respond to these changes in order to foster the continuing health and vitality of the financial services system.

This morning the witnesses will offer the proposition that the most cost-effective way to ensure a strong deposit insurance system is to allow the insured the ability to compete and make a profit in today's changed marketplace. This school of thought certainly is not new but it is one that I strongly endorse. Clearly addressing these changes—that is, updating the legal framework to more accurately reflect today's marketplace—is as important today as was the enactment of the Banking Act in 1933.

We look forward to the witnesses' input on these complex and difficult issues. Today the witnesses include George Gould, Under Secretary for Finance, Department of Treasury, and Robert L. Clarke, Comptroller of the Currency.

We will conclude these oversight hearings next week with testimony from the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board.

Senator Proxmire.

Senator PROXMIRE. I have no opening statement.

The CHAIRMAN. Senator D'Amato.

STATEMENT BY SENATOR ALFONSE D'AMATO

Senator D'AMATO. Mr. Chairman, I commend you for holding this hearing. This morning the Banking Committee continues its indepth examination of the adequacy of Federal insurance funds. To date, these hearings have examined the adequacy of depository insurance funds maintained and managed by the Federal Deposit Insurance Corporation [FDIC], the Federal Savings and Loan Insurance Corporation [FSLIC], the Pension Benefit Guaranty Corporation [PBGC], and the Securities Investor Protection Corporation [SIPC]. We have also examined the adequacy of State guaranty funds in the areas of health, life, property, and liability insurance.

Although we have conducted several hearings on the subject of deposit insurance reform, we have yet to find a proposal that would please all of the interested parties or that would not exacerbate the problems already confronted by certain deposit insurance funds. While I think the issue of deposit reform merits the detailed analysis that these hearings provide, I think prudence dictates that we begin to develop some legislative proposals. I do not want to sound alarmist, however, time is running short and if we don't develop a legislative response, public confidence in our financial system will erode further.

Although a majority of banks and thrift institutions are in sound financial condition, the loss of confidence in the financial system could detonate a chain reaction throughout the economy. It is our duty to ensure that the proper measures are taken since we are charged with the obligation of maintaining the safety and soundness of our financial system.

This morning I look forward to the testimony of our distinguished panel of witnesses and any suggestions and proposals they may offer regarding the reform of the deposit insurance system. Since the commencement of this series of hearings we have addressed many alternatives to ensure that depositor confidence is not eroded further. I am particularly concerned with the plight of the FSLIC fund. In view of the fact that nearly 20 percent of the industry is still financially imperiled, it appears that the funds may be grossly inadequate. Therefore, I look forward to working with you and the witnesses that have appeared before the committee to address the problems facing FSLIC and the other deposit insurance funds.

The **CHAIRMAN**. Senator Mattingly.

OPENING REMARKS OF SENATOR MATTINGLY

Senator **MATTINGLY**. Mr. Chairman, I welcome both Mr. Gould and Mr. Clarke. Today, as we continue our oversight of the deposit insurance system, we will hear testimony on how to ensure the survival of banks in the financial arena. I look forward to your insight on this subject. However, I hope this does not turn into another presentation of the money center banks wish list.

The **CHAIRMAN**. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator **DIXON**. Mr. Chairman, I am pleased to be here this morning as the Banking Committee continues its series of hearings on deposit insurance issues. I look forward to hearing from the distinguished Comptroller of the Currency, Robert Clarke, and Under Secretary of the Treasury George Gould.

Deposit insurance reform is not an issue that can be considered in isolation; the strength of our deposit insurance system depends in no small part on the financial health of our Nation's banking and thrift industries. This is a time of great financial challenge for our savings and loans. It is also a time of tremendous changes in the financial services marketplace.

We need to respond to these changes and make the changes in Federal banking and thrift law that are essential if our banks and thrifts are to be able to adjust to the changes in the marketplace. We cannot let the evolution of financial services be governed solely by the courts, or by those most creative in exploiting loopholes or gaps in the current regulatory structure.

I think it is time, in fact, long past time, to act on legislation that addresses the nonbank bank issue, the question of expanded asset powers for banks, the problems of the thrifts, and a variety of other questions.

I appreciate the willingness of the Comptroller and the Under Secretary to provide the committee with the benefit of their expertise and with their recommendations for legislative action. I hope the committee will soon act on a package of bills that addresses many of the issues that have so long awaited resolution. I am not predicting that we will be able to achieve final action this year on all pending matters; however none of them will be resolved unless we begin to move forward.

The **CHAIRMAN**. Mr. Secretary, please go ahead.

STATEMENT OF GEORGE D. GOULD, UNDER SECRETARY OF FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. **GOULD**. Mr. Chairman, members of this distinguished committee, I have submitted a rather long document this morning and if I may, for the purposes of this hearing, read portions but skip other portions, particularly those that deal with specific numbers or more technical details.

The **CHAIRMAN**. Not only will it be permitted, we appreciate it.

Mr. **GOULD**. All right, sir.

I greatly appreciate this opportunity to appear before your committee. You have faced numerous significant financial issues over the past few years, and I believe you have striven to keep the legal and regulatory structure in step with a rapidly evolving marketplace. That challenge is still present today, perhaps more than ever. I am pleased to have a chance to work with this committee and perhaps to contribute to its important deliberations. While I have had some opportunity to meet many of this committee's members individually, I look forward to getting to know all of the members soon.

ADDRESSING THREE TOPICS

My testimony addresses three topics. First, I would like to say a few words about the prospects of the Nation's insured depository institutions and their ability to serve consumers, businesses, and themselves. Second, I will discuss the problems of thrifts and the FSLIC, and offer some suggestions on how we might cope with them better. Third, my testimony touches on some other deposit insurance issues—related specifically to how we might increase the fairness and effectiveness of the FDIC's operations.

I am also pleased to note that my colleagues and I have attempted to offer this committee complementary statements. Comptroller Clarke will expand on my remarks about banks' abilities to serve the public and maintain financial health. Later this month, Chairman Seidman will share some more detailed ideas about strengthening deposit insurance operations. And we have been working closely with Chairman Gray to develop some practical solutions to help FSLIC.

Any deposit insurance system can only be as strong over time as the industry it is indirectly insuring. And an industry can remain financially healthy only if it can compete effectively to serve consumers and other customers.

In the past, banks competed among themselves in a special business preserve created by law. Neither technology nor changing customer demands posed a real threat. Dissatisfaction with service was communicated through Congress or the regulators as much as through the market.

Those days are gone, and they should be. The price for the banks' security was paid for by consumers, who had ceilings on savings rates and limited investment options; by businesses, many of which were forced to raise funds through less efficient banking intermediaries; and by society, which made saving less attractive and restricted the development of investment instruments that reduce and spread risks.

There are many beneficiaries of the new era—consumers, small savers, business borrowers, and our international competitive position in a critical service industry. But even if one were willing to sacrifice the interests of these groups in order to turn the clock back for banks, the deed could not be done. The marketplace, technology, and consumer preferences have moved ahead. The big problem today is that banks are falling behind, with a possible consequence for safety and soundness in the not too distant future.

Let me offer a few examples.

GROWTH AND DIVERSIFICATION OF SECURITIES

On the asset side, the growth and diversification of securities stand out as a major competitive challenge to the depositories loan portfolio business. Many hitherto illiquid loans—mortgages, commercial paper, even car and other consumer loans—are now securitized. These securities offer low-cost, risk-diversified, high-return vehicles for transferring funds from savers to spenders and investors.

The whys and wherefores of this evolution are too detailed to discuss at length in this statement. In brief, advances in computers and communications have made packaged transactions and investments less expensive, more flexible, and more available. Investors can acquire more detailed information about the characteristics and risk profiles of myriad investment opportunities without relying on banks to intermediate through their portfolios. The securities numbers and effects are as notable as their names and acronyms.

My written statement sets out some particular data on commercial paper and mortgage-backed securities.

Changes on the liability or deposit side of the banking business are just as striking. Money market funds were just the first shot in the struggle for savers' money. And any perusal of the investment advertisements in today's papers reveals that bank investments are the stragglers. The Wall Street Journal's Business Bulletin of February 20 led off with the alert that: "Banks scramble for IRA dollars as interest rates decline." This report and others explain that bank and thrift CD's are losing the contest for middle-class savings to the mutual funds.

If banks cannot evolve, the term "counting house" industry may before long become an epitaph like "smokestack" or "rust bowl." This trend is understandably hard for most of us to accept, schooled as we have been by banking's historical image of affluence and influence. We see some quarterly profits that look reasonable, but the indicators of long-term expectations about returns on banks' equity are difficult to ignore.

Weak banks translate into weak deposit insurance funds. Such weakness also means that we are wasting a valuable and vital business that can help consumers, small savers, American industry, and our international competitiveness. Economists call them end-users, but banks call them customers. Banks are trying to adapt, straining to offer more and better services. Appropriately enough, they are seeking different niches, depending upon their size, location, experience, and comparative advantage. But their common problem is that they are hemmed in by out-of-date legal constraints.

I urge the Congress to reconsider and clarify the services that banking organizations may offer their customers. This is not just a matter of competitive equity, but one of competitive survival. If bank holding companies' authority to compete in familiar business areas such as commercial paper, mutual funds, municipal revenue bonds, and mortgage-backed securities is not clarified soon, they run the risk of being bypassed permanently.

SIPC's policy statement essentially provides a rebuttable presumption that customers' cash (free credit) balances on which interest is paid are created and maintained for the purpose of purchasing securities. SIPC's statement refers to both money "deposited" and money "left" in a securities account for the purpose of purchasing securities. This dual reference thus encompasses not only funds that are initially given to a broker-dealer by the customer, but also monies paid to a broker-dealer as dividends or interest on the customer's securities or as proceeds from the sale of the customer's securities. SIPC's statement, however, explicitly excludes from SIPA coverage interest-bearing cash (free credit) balances that are maintained solely for the purpose of earning interest.

SIPC's statement also indicates that the payment of interest in and of itself for a period of four or five months would not overcome the presumption of SIPA coverage. SIPC has retained the right, however, to

challenge this presumption in any liquidation proceeding of a broker-dealer by the introduction of substantial evidence to the contrary showing that the investor's funds were maintained in an account solely for the purpose of earning interest.

Since SIPA protection is available only for a cash balance in an account for the purpose of purchasing securities or as a result of a sale of securities, the Commission cautions persons who deposit or leave money with a broker-dealer solely for the purpose of earning interest that, based on SIPC's statement, they would not be entitled to SIPA protection. The Commission also cautions broker-dealers that they must consider this limitation in connection with their advertising, promotional and selling practices regarding interest-bearing free credit balances.

II. ADVERTISING, PROMOTIONAL AND SELLING PRACTICES BY BROKER-DEALERS

Some broker-dealers appear to be engaging in questionable advertising, promotional and selling practices when soliciting funds from existing customers or when soliciting funds for new accounts from other investors specifically for the purpose of creating or maintaining free credit balances on which interest will be paid. These practices raise questions under SIPA and under the rules of SRO's and the Commission when they induce investors to deposit or leave funds with a broker-dealer solely for the purpose of earning interest.

Pursuant to Section 15(d) of SIPA, members of SIPC must comply with the prohibition on advertising specified in SIPC's bylaws. 5/ In addition, Rule 436 of the New York Stock Exchange, Inc. ("NYSE") prohibits a member organization (other than a member organization that is subject to supervision of state banking authorities) from paying interest on any free credit balance created for the purpose of receiving interest. 6/ Finally, the NYSE's constitution and rules, the Rules of Fair Practice of the National Association of Securities Dealers, Inc. ("NASD") and the Commission's SECO Rule 15b10-2 under the Securities

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5/ SIPC's advertising bylaw, among other things, prohibits member firms from (i) either displaying any sign or symbol or including in any advertising, promotional or other material any statement or explanation relating to SIPC or SIPC membership other than the official brochure, symbol, advertising or explanatory statement approved by SIPC, and (ii) advertising by means of the official symbol, official advertising statement or official explanatory statement if SIPA would not under most circumstances provide protection with respect to the investment advertised. See Article 11, Section 4(g) of SIPC's bylaws. A broker-dealer that advertises SIPA protection of customers' funds when the broker-dealer's practices induce customers to deposit those funds solely for the purpose of earning interest is violating SIPC's advertising bylaw.

6/ NYSE Rule 436 states that:

> No member organization, unless subject to supervision by State banking authorities, shall pay interest on any credit balance created for the purposes of receiving interest thereon. Credit balances arising out of transactions in securities or commodities or incidental to any business regularly carried on by a member organization prior to August 2, 1933, shall not be subject to the provisions of this Rule unless it appears that such credit balances have been increased solely for the purpose of receiving interest thereon.

In addition, the NYSE has interpreted that rule as follows:

> Reinvestment
>
> Interest may be paid on 'free' credit balances left with a member organization for the purpose of reinvestment or temporarily being held awaiting investment. Member organizations should, however, devise a method for determining whether the credit balance is left for investment or reinvestment purposes to ensure that such funds are fully protected by SIPC (e.g., not being deposited solely to earn interest) and that its activities do not violate applicable banking laws. (Also see definition of 'customer' in the Securities Investor Protection Act, Section 16(3) [sic], NYSE Guide-Volume 3.)
>
> Solicitation of Credit Balances
>
> Member organizations and their associated persons may not solicit the deposit or retention of free credit balances from customers for the purpose of paying interest thereon, unless the member organization is registered under and subject to the banking laws. Special compensation paid to associated persons in this regard may be deemed evidence of solicitation.

NYSE, Interpretation Handbook, NYSE Rule 436, at 4380 (September 1981).

Exchange Act of 1934 require member and nonmember broker-dealers to observe "high standards of commercial honor" and "just and equitable principles of trade" in the conduct of their business. 7/

Misrepresentations by broker-dealers about the availability of SIPA protection and other misleading advertising, promotional and selling practices by broker-dealers that could result in a denial of "customer" status under SIPA because such practices induce investors to deposit or leave funds with a broker-dealer solely for the purpose of earning interest are inconsistent with just and equitable principles of trade. 8/ Those practices not only are unethical but also may violate NYSE Rule 436 or Section 15(d) and SIPC's advertising bylaw. In addition, broker-dealers opening a new customer account or holding customer funds in an existing account establishing a free credit balance have a duty not to misrepresent the circumstances under which SIPA

7/ *See* Article I, Section 2(a) of NYSE constitution; Article III, Section 1 of the NASD's Rules of Fair Practice, NASD Manual (CCH) ¶2151; and 17 CFR §240.15b10-2.

8/ For a discussion of the meaning of "just and equitable principles of trade," *see In re Valley Forge Securities Co.*, 41 S.E.C 486 (1963); *In re NASD, Inc.*, 19 S.E.C. 424, 480 (1945) (Comm'r Healey, dissenting in part); L. Loss, *The SEC and The Broker-Dealer*, 1 Vand.L.Rev. 516, 521 (1948); II L. Loss, *Sec. Reg.* 1359, 1363-64 & n.11 (2d ed. 1961). *See also Buchman v. Securities & Exchange Comm'n*, 553 F.2d 816, 821 (2d Cir. 1977) (test for violation of ethical standard embodied in Article III, Section 1 of the NASD's Rules of Fair Practice is "bad faith").

coverage for that balance may be available. 9/ Accordingly, broker-dealers that pay interest on free credit balances should review their procedures to ensure that they are not misleading their customers as to the existence of SIPA coverage.

Some of the advertising, promotional and selling practices by broker-dealers that may raise questions under the above rules include:

1. Advertising the payment of interest on customers' free credit balances and representing the availability of SIPA coverage without disclosing the limitations on that coverage.
2. Encouraging customers not to invest in money market funds because of the absence of SIPA protection; and instead, based on representations of the availability of SIPA coverage for free credit balances, encouraging customers to deposit funds with a broker-dealer in accounts establishing those balances solely to earn interest.

9/ If a broker-dealer makes any representation about the availability of SIPA protection, he must be sure that representation does not mislead customers as to the nature and extent of SIPA coverage.

3. Inducing customers to create and maintain interest-bearing free credit balances on the basis that those balances will be invested in Treasury bills or maintained in a special reserve account when in actuality the broker-dealer uses the funds primarily to finance other customers' margin loans as permitted by Rule 15c3-3. 10/

4. Compensating salesmen on the basis of the amount of free credit balances in the accounts of customers, so that salesmen induce customers to create, maintain or increase interest-bearing free credit balances, without regard to market conditions, for long periods of time without related securities transactions. 11/

Therefore, misrepresentations by broker-dealers about the availability of SIPA protection for interest-bearing free credit balances and other misleading advertising, promotional and selling practices that could result in a denial of "customer" status under SIPA will be deemed violations of Section 15(d) of SIPA, NYSE Rule 436 and the rules of the self-regulatory organizations and the Commission concerning just and equitable principles of trade.

By the Commission.

George A. Fitzsimmons
Secretary.

November 17, 1981.

10/ See 17 CFR §240.15c3-3.

11/ See also interpretations of NYSE Rule 436, supra note 6.

Small banking organizations in particular need the freedom to aid consumers and to help themselves by offering insurance, real estate brokerage, and other local services. Banks have been shut off from these activities not because of risk, but because of powerful interest groups who want to preclude competition. Moreover, the whole of the benefits for savers exceeds the competitive gain from the sum of the individual services. If banking organizations can diversify, they can offer integrated financial planning to savers who cannot afford expensive investment advisers.

If the Congress does not wish to deal specifically with each new line of business for banks, it could permit the Federal Reserve Board to authorize bank holding company activities of a financial nature, with whatever limits the Congress considers appropriate.

Some people who are concerned about the financial future of depositories have determined the best course is to sacrifice the consumer or other users of bank services. They seek to hold back new entrants and competitors from entering the bank and thrift industries. One can understand this approach, especially from those used to the system that prevailed before communications-computer technology and consumer-saver preferences opened up the marketplace.

Nevertheless, it is a mistaken approach for anyone concerned about services to the public. Moreover, I fear it could be a dangerous course from a safety and soundness perspective, because we would waste energy trying to hold back the rising waters instead of seeking to channel them toward prudent and productive uses.

The so-called nonbank bank is perhaps the prime example of this challenge. Even the name, along with its accessory loophole, is designed to evoke opposition. One wonders what would have been the future of discount brokers, if some public affairs genius for securities firms had tarred them effectively with the term "nonbroker broker."

NONBANK BANKS CONTRIBUTION TO CONSUMERS

I cannot discover anything wrong with a bank that orients its business toward consumers. Indeed, it can bring additional capital, skills, competition and perhaps retailing expertise to the banking system. Some noteworthy groups have moved past the labels to come to the same conclusion. For example, the American Association of Retired Persons has announced its support for a form of nonbank bank.

Like other primarily middle class groups, senior citizens want to be smart investors, but they struggle to understand the diversity of available products. Why should we stop firms from focusing their business expertise on meeting this need?

Small businesses, too, can be served well by the nonbank bank, albeit in a different form. It is, of course, important to examine how these new banks will be regulated and supervised. The first answer, contrary to the statements of some, is that consumer banks are chartered and regulated by State and national banking authorities, just like all other banks. Indeed, a family bank bill that has been introduced would subject them to more stringent community service and capital requirements than banks and thrifts face.

It is also important to ask about the regulation of transactions and affiliations between the consumer bank and its parent. A concern for the safety of the bank payments system may merit requiring certain commitments by the parent firm or structural intermediaries between parent and bank. The blunt approach to this task is simply to prohibit nonbank banks altogether. But then we have lost the many benefits of these new entrants. Moreover, the prohibition approach runs the sizable risk of failing to hold back market change and thus missing an opportunity to develop the right regulation from the start.

There already are a number of laws that govern the relations between nonbank banks and their parents. The Treasury Department would certainly welcome, however, a charge by the Congress to work with the financial institutions' regulators to develop uniform rules on the affiliations between nonbank banks and their parents.

I recognize that for many people the problems of the thrifts and FSLIC comprise the most important deposit insurance issue. The administration shares this interest in addressing the thrift industry's problems in a prompt fashion. Indeed, given the decline in interest rates and the current substantial profits of many thrifts, this is a propitious time to make headway. Today, I would like to report to you on: One, the estimates of the size of the problem; two, the limits of FSLIC's current resources; and three, a suggested approach toward solving these problems.

Anyone's estimates of the cost of resolving problem thrift cases entails considerable uncertainty. The hesitation is partially attributable to important variables, such as interest rates and regional real estate conditions that may affect significantly the health of many institutions over time. In addition, Congress and the Federal Home Loan Bank Board have the option of permitting many institutions that are liquid, but technically insolvent, to remain open.

To summarize my written statement, the recently published reports estimate a range of 200 to 460 problem thrift institutions with assets of $60 to $120 billion and resolution costs between 5 and 20 percent. They suggest that the total cost of assistance would range from about $5 to $25 billion. Chairman Gray's response to Chairman Garn earlier this year appraised the resolution costs at almost $17 billion.

FSLIC need not incur all these costs immediately. Indeed, as an organizational matter, FSLIC may need to prolong its assistance effort. Deferring the resolution of problem institutions does, however, entail risk. Therefore, we believe that it is in FSLIC's, the industry's, and the public's interest to step up both the resolution and supervision effort considerably.

FSLIC must cope both with financial and organizational constraints. The Federal Home Loan Bank Board has just reported that FSLIC's total reserves, assets minus liabilities, at the end of 1985 totaled about $6 billion. If FSLIC's allowance for losses for various assets are low, as some commentators have asserted, then its total reserves would be commensurately lower.

The Federal Home Loan Bank Board and FSLIC are expanding staff considerably so as to handle better their supervisory and problem case resolution responsibilities.

Despite these substantial efforts to expand organizationally, there are limits on FSLIC's capability to increase its case resolution efforts.

THREE-PRONGED STRATEGY TO HELP S&L'S AND FSLIC

We recommend a three-pronged strategy to help the thrift industry and FSLIC.

First, we need to strengthen the thrift industry as a whole. We must set targets and create incentives for the industry to increase its capital. Concurrently, we need to halt the growth of the problem through improved supervision.

Second, we must enhance FSLIC's resources so that it can handle a greater number of insolvent institutions. FSLIC needs additional funds if we wish to make more progress more quickly. To avoid placing too great a burden on the industry at once, the funds for FSLIC should be a balance of industry assessments and prudent borrowing or investment from the Federal home loan banks. In effect, FSLIC could borrow against its future stream of assessment and investment income to avoid encumbering the industry with a full capitalization effort immediately.

Third, we can lower the resolution costs that FSLIC and the industry must pay if we manage to increase the demand from acquirers and enhance the franchise value of ailing thrifts. New entrants can also increase the industry's overall capital base and long-term health.

We recognize that interindustry thrift acquisitions are a touchy subject for many parties, especially some segments of the industry that wish to avoid competition. But the acquisition logic is straightforward and undeniable. The problem institutions have created real costs that FSLIC and the industry must bear. Neither the Congress nor the administration is in the mood to accept a budget-busting bailout, although we can help in other nonexpenditure ways. So if the thrift industry wants to cut its costs, it should not close out potential acquirers.

We acknowledge that the thrift industry problem will not be solved overnight. But interest rates are down and many in the industry are enjoying exceptional profits. This is the time to move forward vigorously with the elements of this three-part program.

Because I discuss each of these points in greater detail in my written statement, if I may, I'll just highlight a few of the points here.

FSLIC's estimated income before expenses for 1986 is about $2.6 billion, including a little over $1 billion from another year of the special assessment. There have been numerous suggestions about ways to raise more capital for FSLIC. The proposals include a special 1-percent recapitalization, an increase in the special assessment, and a merger with the FDIC. We would prefer to avoid these measures for now, if possible. Instead, we believe the current contributions to FSLIC can be combined with carefully evaluated borrowing and investments from the Federal home loan banks, spaced out over time.

To date, the assistance of the 12 Federal home loan banks has remained relatively minor. These banks are owned by the industry, but linked to the Home Loan Bank Board in myriad ways.

The Garn-St Germain Act authorized the Federal Home Loan Bank Board to direct the banks to lend to FSLIC. There are possible variations on this loan approach, perhaps involving deposits, subordinated debt, and preferred stock. Authorizing legislation may be necessary for investments in FSLIC. Furthermore, any financing package must be attentive to the Federal home loan bank's position in the debt markets and to the operating needs of the thrift industry.

I met last week with the 12 presidents of the Federal home loan banks to discuss our ideas with them. They gave me some important insights. Most important, the Federal home loan bank presidents are anxious to work with the Congress, the Bank Board and the Treasury to fashion additional Federal home loan bank support for FSLIC. We, in turn, will seek to arrange a Federal home loan bank financial package that taps the banks' skills and resources responsibly.

In summarizing our position on the thrifts, we wish to engage the Congress in this effort to help strengthen thrifts and resolve FSLIC's problems. We value highly your experience and insights. Equally important, we need your help to make real progress with the many players involved. We can make a start alone, but together we can develop a meaningful program that will make a difference.

When Profs. Milton Friedman and John Kenneth Galbraith are in agreement on an economics issue, I usually find it worthwhile to listen. And so it is on deposit insurance. Both gentlemen have stressed the key systemic protection afforded the Nation's financial network by deposit insurance. Moreover, it is important for America's small savers to have at least one totally safe investment.

I stated earlier that over time a deposit insurance system can only be as strong as the industry it stands behind. We are urging the Congress to permit the depository institutions to evolve with their marketplace, for the sake of the customers they serve and the very health of those financial institutions. In addition, we must also recognize that periods of market adjustment, whether or not we wish it, will result in some institutions failing. It happens in all industries. While we need to avoid substantial costs to the public, the failure of less competitive firms is not an altogether unhealthy sign.

Failures of depositories, however, cause problems for the FDIC and FSLIC. Without presaging Chairman Seidman to a great degree, I would like to outline for this committee some important operational failure management issues facing the FDIC.

FDIC NEEDS BETTER TOOLS TO DEAL WITH BANK FAILURES

One frequently mentioned operational issue is the unequal treatment accorded large and small banks. The inequality arises in part because the FDIC does not have the tools to treat different size banks alike, while keeping costs and disruptions down. The FDIC needs the authority both to arrange purchase and assumption transactions with greater flexibility and to ensure that stockholders, managers and liability holders remain at risk.

My written statement discusses these issues at greater length.

One particularly important failure management issue relates to the cost we are willing to force banking customers and the FDIC to bear to preserve historical geographic barriers to competition. Perhaps at one time these barriers had an important local value, but we need to reevaluate their cost today.

The Garn-St. Germain Act only permits interstate rescue mergers of failed institutions of at least $500 million in assets. The same law permits interstate mergers of failing thrifts of any size. The FDIC should not be hamstrung in this fashion, especially if we wish it to: lower resolution costs; seek to maintain service to borrowers, depositors, and the community; and avoid disruptive bank liquidations.

In summary, we believe there is much that can be done to improve the failure management capabilities of the deposit insurance agencies, but many reforms require congressional action. Some issues will force us to reassess where the long-established barriers now hurt local borrowers and savers more than they protect them. The need is clear. The changes wrought by national, even international, financial markets cannot be disregarded. We have an opportunity to adapt our regulatory systems to them, so that consumers and small savers can be served better.

I would like to assist this committee in meeting the challenge. We will make our best effort to press forward now on all three of these consequential topics.

If banking organizations could engage in more services, they could attend much better than they can today to the needs of the public—consumers, small businesses, State and local governments, America's corporations, and others. Just as important, especially from a safety and soundness point of view, is the exigent need for banking organizations to catch up with the evolution of the market. Otherwise, they face economic obsolescence. Their regulation and supervision must adapt, too.

It is to all our advantages to think creatively about safeguards for depositories owned by different types of firms, instead of trying to prohibit market and technological changes that we will never control or prevent. Moreover, the Nation's consumers and small savers show no evidence of wanting to stop these beneficial changes.

The time is also ripe to make major advances on the problems of the thrifts and FSLIC. The necessity is plain and compelling. We must: One, strengthen the industry and limit growth of the problem; two, enhance FSLIC's capability, relying in part on the FHLB banks, to resolve more problem cases; and three, reduce the burden on the industry by bringing in new capital and assisting FSLIC by promoting acquisitions of ailing thrifts.

We also will consider improvements in the deposit insurers' operational ability to manage failures. Some suggestions the FDIC is considering can enhance equitable treatment of banks, lower costs and lessen disruptions to borrowers, depositors, and their communities.

Finally, and equally important, I wish to reaffirm the Treasury's commitment to work closely with this committee and the Congress to address these challenges. We will refine our ideas with you. We will seek to answer your questions. If legislation is appropriate and opportune, we stand ready to assist in ways large and small.

I have appreciated this invitation to present our views today. And I respectfully look forward to many more exchanges in the future.

Mr. Chairman, I would be pleased to answer any questions the committee may have.

[The complete prepared statement follows:]

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

TESTIMONY OF THE HONORABLE
GEORGE D. GOULD
UNDER SECRETARY FOR FINANCE
U.S. DEPARTMENT OF TREASURY
BEFORE THE SENATE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
TUESDAY, MARCH 4, 1986

Mr. Chairman and Members of the Distinguished Committee:

I greatly appreciate this opportunity to appear before your Committee. You have faced numerous significant financial issues over the past few years, and I believe you have striven to keep the legal and regulatory structure in step with a rapidly evolving marketplace. That challenge is still present today, perhaps more than ever. I am pleased to have a chance to work with this Committee, and perhaps to contribute to its important deliberations. While I have had some opportunity to meet many of this Committee's members individually, I look forward to getting to know all of you soon.

My testimony addresses three topics. First, I would like to say a few words about the prospects of the nation's insured depository institutions and their ability to serve consumers, businesses, and themselves. Second, I will discuss the problems of thrifts and FSLIC, and offer some suggestions on how we might cope with them better. Third, my testimony touches on some other deposit insurance issues -- related specifically to how we might increase the fairness and effectiveness of the FDIC's operations.

I also am pleased to note that my colleagues and I have attempted to offer this Committee complementary statements. Comptroller Clarke will expand on my remarks about banks' abilities to serve the public and maintain financial health. Later this month, Chairman Seidman will share some more detailed ideas about strengthening deposit insurance operations. And we have been working closely with Chairman Gray to develop some practical solutions to help FSLIC.

I. Services to the Public and Profitability: The Keys to Safety and Soundness

A. Banks' Changing Marketplace

Any deposit insurance system can be only as strong over time as the industry it is indirectly insuring. And an industry can remain financially healthy only if it can compete effectively to serve consumers and other customers.

In the past, banks competed among themselves in a special business preserve created by the law. Neither technology nor changing customer demands posed a real threat. Dissatisfaction with service was communicated through Congress or the regulators as much as through the market.

Those days are gone. And they should be. The price for the banks' security was paid for by consumers, who had ceilings on savings rates and limited investment options; by businesses, many of which were forced to raise funds through less efficient banking intermediaries; and by society, which made saving less attractive and restricted the development of investment instruments that reduce and spread risks.

There are many beneficiaries of the new era -- consumers, small savers, business borrowers, and our international competitive position in a critical service industry. But even if one were willing to sacrifice the interests of these groups in order to turn the clock back for banks, the deed could not be done. The marketplace, technology, and consumer preferences have moved ahead. The big problem today is that banks are falling behind, with a possible consequence for safety and soundness in the not-too-distant future.

Let me offer a few examples.

On the asset side, the growth and diversification of securities stand out as a major competitive challenge to the depositories' loan portfolio business. Many hitherto illiquid loans -- mortgages, commercial paper, even car and other consumer loans -- are now "securitized." These securities offer low-cost, risk-diversified, high-return vehicles for transferring funds from savers to spenders and investors.

The whys and wherefores of this evolution are too detailed to discuss at length in this statement. In brief, advances in computers and communications have made "packaged" transactions and investments less expensive, more flexible, and more available. Investors can acquire more detailed information about the characteristics and risk profiles of myriad investment opportunities -- without relying on banks to "intermediate" through their portfolios. Securities can even be broken down and "rebundled" to suit special investor tastes -- for example, the collateralized mortgage obligation (CMO), which structures cash flows from mortgage securities to suit different preferences for maturity and uncertainty.

The securities' numbers and effects are as notable as their names and acronyms. In 1980, total commercial paper outstanding amounted to $124 billion while commercial banks' commercial and industrial (C&I) loans amounted to $327 billion. By 1985, commercial paper totaled $303 billion and bank C&I loans were $494 billion -- increases of 143 percent and 51 percent, respectively. Moreover, the competition from commercial paper forced banks to switch a large percentage of their C&I loans from the prime rate to the usually lower money market rates.

Dealer-placed, non-financial commercial paper is most directly comparable with bank C&I loans. The increase in outstandings for this type of commercial paper in the 1980-1985 period was 140 percent, almost three times the increase in commercial bank C&I loans over the same period. (Dealer-placed, non-financial commercial paper outstanding grew from $37 billion to $88 billion -- 11 and 18 percent of C&I loans at the end of 1980 and 1985, respectively.)

Mortgage-backed securities supply another example of the remarkable transformation of illiquid assets into easily traded securities. From modest beginnings in the early 1970's, outstanding mortgage-backed securities of various kinds now total about $375 billion.

Changes on the liability, or deposit, side of the banking business are just as striking. The well-known money market funds took advantage of much lower cost organizations to offer savers a higher return. In part because the Congress passed the Depository Institutions Deregulation and Garn-St Germain Acts, banks have been able to counter the money market funds to a degree. (Nevertheless, between 1980 and 1985, consumer deposits in commercial banks increased by 85 percent while the non-institutional holdings of money market funds increased by over 250 percent.)

Money market funds were just the first shot in the struggle for savers' money. And any perusal of investment advertisements in today's papers reveals that bank investments are the stragglers. The Wall Street Journal's "Business Bulletin" of February 20 led off with the alert that "Banks Scramble for IRA dollars as interest rates decline": This report and others explain that bank and thrift CD's are losing the contest for middle class savings to mutual funds. Meanwhile, Federal district courts disagree over whether banks can offer competitive collective retirement trust accounts.

If banks cannot evolve, the term "counting house" industry may before long become an epitaph like "smoke stack" or "rust bowl." This trend is understandably hard for most of us to accept, schooled as we have been by banking's historical image of affluence and influence. We see some quarterly profits that look reasonable. But the indicators of longer-term expectations about returns on banks' equity are difficult to ignore.

Mr. James McCormick, in testimony before this Committee last year, contended that relative financial performance of major banks has been slipping for about 15 years, as measured by a capital asset pricing model. While bank stocks have moved up with other stocks since the time of that testimony, Mr. McCormick's basic findings about major banks' relative financial performance still appear sound. Poor performance means banks will have a harder time attracting capital; the attempts to earn a higher return in their traditional, limited sphere of business may even increase their loan portfolio risk.

Weak banks translate into weak deposit insurance funds. Such weakness also means that we are wasting a valuable and vital business that can help consumers, small savers, American industry, and our international competitiveness. Economists call them "end-users," but banks call them customers. Banks are trying to adapt, straining to offer more and better services. Appropriately enough, they are seeking different niches -- depending on their size, location, experience, and comparative advantage. But their common problem is that they are hemmed in by out-of-date legal constraints.

I urge the Congress to reconsider and clarify the services that banking organizations may offer their customers. This is not just a matter of competitive equity, but one of competitive survival. If bank holding companies' authority to compete in familiar business areas such as commercial paper, mutual funds, municipal revenue bonds, and mortgage-backed securities is not clarified soon, they run the risk of being bypassed permanently.

Banks' prospects are looking even worse in light of recent court decisions about commercial paper services. Unless reversed by the courts or the Congress, these decisions would force banks to give up business they have handled for years. This retrogression would hurt both business customers and investors.

Small banking organizations in particular need the freedom to aid consumers and to help themselves by offering insurance, real estate brokerage, and other local services. Banks have been shut off from these activities not because of risk, but because powerful interest groups want to preclude competition. Moreover, the whole of the benefits for savers exceeds the competitive gain from the sum of individual services: If banking organizations can diversify, they can offer integrated financial planning to savers who cannot afford expensive investment advisors.

If the Congress does not wish to deal specifically with each new line of business for banks, it could permit the Federal Reserve Board to authorize bank holding company "activities of a financial nature," with whatever limits the Congress considers appropriate. And it is certainly hard to understand why the Congress should not at least grant banking organizations the authority to sponsor mutual funds that would be available for middle class savings -- so small savers can benefit from their competitive service.

B. Consumer Banks

Some people who are concerned about the financial future of depositories have determined the best course is to sacrifice the consumer, or other users of bank services. They seek to hold back new entrants and competitors from the bank and thrift industries. One can understand this approach, especially from those used to the system that prevailed before communications-computer technology and consumer-saver preferences opened up the marketplace.

Nevertheless, it is a mistaken approach for anyone concerned about services to the public. Moreover, I fear it could be a dangerous course from a safety and soundness perspective -- because we would waste energy trying to hold back the rising waters instead of seeking to channel them toward prudent and productive uses.

The so-called nonbank bank is perhaps the prime example of this challenge. Even the name, along with its accessory "loophole," is designed to evoke opposition. One wonders what would have been the future of discount brokers if some public affairs genius for securities firms had tarred them effectively with the term "nonbroker broker."

I cannot discover anything wrong with a bank that orients its business toward consumers. Indeed, it can bring additional capital, skills, competition, and perhaps retailing expertise to the banking system. Some noteworthy groups have moved past the labels to come to the same conclusion: For example, the American Association of Retired Persons has announced its support for a form of nonbank bank.

Like other primarily middle class groups, senior citizens want to be smart investors, but they struggle to understand the diversity of available products. Why should we stop firms from focusing their business expertise on meeting this need?

Small businesses, too, can be served well by the nonbank bank, albeit in different form: the kind of bank that foregoes demand deposits but offers commercial loans. These lenders are serving as conduits between the large deposit and commercial paper markets, and businesses that are not big enough to issue securities. It is, of course, important to examine how these new banks will be regulated and supervised. The first answer, contrary to the statements of some, is that consumer banks are chartered and regulated by state and national banking authorities -- just like all other banks. Indeed, a "family bank" bill that has been introduced would subject them to more stringent community service and capital requirements than banks and thrifts face.

It is also important to ask about the regulation of transactions and affiliations between the consumer bank and its parent. A concern for the safety of the bank payments system may merit requiring certain commitments by the parent firm, or structural intermediaries between parent and bank. The blunt approach to this task is simply to prohibit nonbank banks altogether. But then we have lost the many benefits of these new entrants. Moreover, the prohibition approach runs the sizable risk of failing to hold back market change and thus missing an opportunity to develop the right regulation from the start.

There already are a number of laws that govern the relations between nonbank banks and their parents. The Treasury Department would certainly welcome, however, a charge by the Congress to work with the financial institutions regulators to develop uniform rules on the affiliations between nonbank banks and their parents.

My closing comment on consumer banks relates to thrifts. As I discuss below, one way to reduce the size of the problem borne by the thrift industry and FSLIC involves permitting more firms to purchase ailing thrifts. Currently, some laws, Federal Reserve Board policies, industry opposition, and pending legislation have stymied would-be purchasers. Some rejected firms that want to offer financial services have formed consumer banks.

Congress may wish to consider reducing the barriers encountered by these potential acquirers -- thereby channeling potential consumer bank entrants toward thrifts, reducing FSLIC's costs (and the S&L industry's ultimate burden), and bringing new capital into the industry. Without a significant Congressional effort, however, we could end up cutting off valuable new providers of services to middle class consumers and not help thrifts.

II. The Problems of the Thrifts and FSLIC

I recognize that for many people the problems of the thrifts and FSLIC comprise the most important deposit insurance issue. The Administration shares this interest in addressing the thrift industry's problems in a prompt fashion. Indeed, given the decline in interest rates and the current substantial profits of many thrifts, this is a propitious time to make headway. Today, I would like to report to you on: (1) estimates of the size of the problem; (2) the limits of FSLIC's current resources; and (3) a suggested approach toward solving these problems.

A. Problem Size

Anyone's estimate of the cost of resolving problem thrift cases entails considerable uncertainty. The hesitation is partially attributable to important variables -- such as interest rates and regional real estate conditions -- that may affect significantly the health of many institutions over time. In addition, Congress and the FHLBB have the option of permitting many institutions that are liquid but technically insolvent to remain open.

The most common method of calculating the set of problem institutions is through net worth analysis, which is based on an examination of a thrift's capital. There are various ways to measure a thrift's capital base, but the two most prevalent approaches rely on GAAP (Generally Accepted Accounting Principles) and RAP (Regulatory Accounting Principles, which include special adjustments that increase capital).

As of September 30, 1985, there were 461 GAAP-insolvent thrifts insured by FSLIC. These thrifts had assets with a book value of $114 billion; 236 of them were unprofitable in the third quarter.

As of the same date, there were 105 RAP-insolvent thrifts insured by FSLIC. Their assets totaled $22 billion, and only four had net income in the third quarter.

The table attached to this statement gives a fuller exposition of the possible problem set. In particular, it supplies (1) statistics for a narrower net worth measure, tangible net worth (TAP), which excludes goodwill and other intangible assets, and (2) data on thrifts with net worth between 0 and 3 percent of assets.

One can refine the analysis of thrifts' financial soundness by examining factors such as quality of profits, duration match between assets and liabilities, and portfolio composition. Indeed, FSLIC employs this detail to select its case load, which currently consists of about 90 thrifts with assets of approximately $40 billion. The FHLBB's Office of Examination and Supervision also uses the financial detail from "call reports" to develop a "next tier" list of significant supervisory cases.

Moving from these statistics on troubled thrifts to identification of a number that will require FSLIC's assistance involves considerable supposition and judgment. The Bank Board, the GAO, and various academicians have published a number of analyses of potential demands on FSLIC. Under present conditions, their estimates of the number of thrifts requiring at least some direct assistance range between 200 and 460 institutions. Their estimates of the book value of assets involved runs from $60 to $120 billion.

Any estimate of resolution costs is equally indefinite. A few years ago, when "interest rate spread" cases dominated FSLIC's case load, resolution costs were about five percent or less of an institution's assets. But the surge in cases involving poor quality assets has increased that percentage considerably. Estimated resolution costs as a percentage of assets in 1985 and 1984 were about 15 percent. If asset quality cases diminish in size and number, this percentage could fall considerably.

In sum, the recently published reports estimate a range of 200-460 problem thrifts, with assets of $60-$120 billion and resolution costs between 5-20 percent. They suggest that the total cost of assistance would range from about $5-$25 billion. Chairman Gray's response to Chairman Garn earlier this year appraised the resolution costs at almost $17 billion.

FSLIC need not incur all these costs immediately. Indeed, as an organizational matter, FSLIC may need to prolong its assistance effort. Deferring the resolution of problem institutions does, however, entail risk. An increase in interest rates will cause additional losses. Without appropriate supervision, thrifts in a precarious position may take actions that increase risk and possibly ultimate loss. Even with careful supervision, FSLIC may end up assuming the operating losses from thrifts that continue to lose money. Therefore, we believe it is in FSLIC's, the industry's and the public's interest to step up both the resolution and supervision effort considerably.

B. FSLIC's Resources

FSLIC must cope both with financial and organizational constraints. The FHLBB has just reported that FSLIC's total reserves (assets minus liabilities) at the end of 1985 totaled about $6 billion. If FSLIC's "allowances for losses" for various assets are low, as some commentators have asserted, then its total reserves would be commensurately lower.

FSLIC's annual income comes from its regular deposit insurance assessments (one-twelfth of one percent of deposits), investment income, and a special assessment (at most, one-eighth of one percent annually). We estimate that FSLIC's 1986 income before expenses should total about $2.6 billion, of which a little over $1 billion is from the special assessment.

FSLIC-Insured Institutions (September 30, 1985)

	All	Insolvent			Low Net Worth - 0-3% of Assets			Total - 3% Net Worth or Less		
		RAP 1/	GAAP 2/	TAP 3/	RAP	GAAP	TAP	RAP	GAAP	TAP
Number of firms	3,224	105	461	686	680	788	788	785	1,249	1,474
Assets ($billions)	1,042	22	114	343	253	320	346	275	434	689
Net Worth/Assets (%) (as measured, respectively, by RAP, GAAP, and TAP)		-4.9	-3.3	-4.7	1.93	1.84	1.63	1.38	.47	-1.5
Firms with positive net income in 3rd quarter	2,611	4	225	377	421	587	628	425	812	1,005
Net income ($millions)	1,052	-380	-379	-169	-60	91	462	-440	-288	293
Annualized ROA (%)	.41	-6.80	-1.32	-.20	-.10	.12	.54	-.64	-.27	.17

Source: FHLBB's Office of Policy and Economic Research

1/ Regulatory net worth.

2/ Net worth as defined under Generally Accepted Accounting Principles.

3/ Tangible net worth — GAAP net worth less goodwill and other intangible assets.

The time also is ripe to make major advances on the problems of the thrifts and FSLIC. The necessity is plain and compelling. We must: (1) strengthen the industry and limit growth of the problem; (2) enhance FSLIC's capability, relying in part on the FHLBanks, to resolve more problem cases; and (3) reduce the burden on the industry by bringing in new capital and assisting FSLIC by promoting acquisitions of ailing thrifts.

We also will consider improvements in the deposit insurers' operational ability to manage failures. Some suggestions the FDIC is considering can enhance equitable treatment of banks, lower costs, and lessen disruptions to borrowers, depositors, and their communities.

Finally, and equally important, I wish to reaffirm the Treasury's commitment to work closely with this Committee and the Congress to address these challenges. We will refine our ideas with you. We will seek to answer your questions. If legislation is appropriate and opportune, we stand ready to assist in ways large and small.

I have appreciated this invitation to present our views today. And I respectfully look forward to many more exchanges in the future.

Mr. Chairman, I would be pleased to answer any questions the Committee may have.

REVOLUTIONARY CHANGES IN THE FINANCIAL SERVICES INDUSTRY

The CHAIRMAN. Thank you very much, Mr. Secretary.

Several years ago, even before I became chairman of this committee, I started talking a good deal about the revolutionary changes that were occurring and the rapidity of those changes and there were a lot of critics who said, "Relax, sit back, we don't need to do anything. And you're wrong."

I would like to confess that I was wrong. It's happened much more rapidly than I anticipated and I would appreciate it if some of those critics would go back and review what has taken place over the last 5 years and the fact that it has now been 3½ years since Congress has done anything. Talk about fiddling while Rome burns. Since Garn-St Germain passed, we have done nothing, absolutely nothing. And yet in those 3½ years the change has been even more rapid than ever.

So I am pleased that your testimony recognizes that Treasury appears to be willing to be of help to see if we can't expand the list of permissible activities for bank holding companies, attempt to shore up the resources of the FSLIC, and certainly I think we need to broaden the list of potential acquirers for failing institutions.

You supported the concept of operation of consumer banks and when we've talked about the need to expand the list of potential acquirers for failing institutions, would you think that consumer banks would lessen the number of potential bidders for failing institutions? Wouldn't it be more profitable for some to be able to open consumer banks and provide those services rather than taking on the problems of failing institutions? Do we have a conflict there between those two ideas?

Mr. GOULD. I don't think our position has changed, Mr. Chairman, since Jim Baker testified back in June of last year with respect to that when, I believe, you asked him about the consumer bank. He underlined the need to treat consumer banks in the context of a broad banking bill, a bill that recognized that there were a variety of forms under which the consumer advantages of a consumer bank could be offered, and that the problem shouldn't be just looked at in isolation.

I don't think therefore, that there is a conflict in those ideas because what we are saying about consumer banks is that they are procompetitive. They have an opportunity, through a specific market focus, to serve an element of the public that we feel is worth serving and can be served better. But we also point out that that could be accomplished by channeling this interest into the thrift industry and that the same proconsumer benefits could be achieved in that manner.

Now if you were to say to me that I could have a choice of dealing with an ailing thrift and having to put in a lot of work or doing something de novo—starting up a consumer bank or a family bank that had no problems—in many instances the latter might be my answer. Yes, I'd rather start de novo. But I think that Congress has the opportunity to resolve that conflict or that problem by first opening the way for new entrants into the thrift industry. With that accomplishment behind it, then one can look at maintaining the franchise value of ailing thrifts by dealing with the so-called nonbank bank—but in the context of both a broad bill and an effort to open the way for channeling that capital toward thrifts. That effort: One, can serve the consumer, and two, can help us solve a national problem.

BROADEN THE LIST OF S&L ACQUIRERS

The CHAIRMAN. Let's turn to the side of the equation of trying to broaden the list of potential acquirers for failing S&L's and banks.

Would you preclude acquisition by any type of company?

Mr. GOULD. We don't see why anyone should be precluded providing that the work is done to protect the payments system and to prevent unfair competition that could result by some tie-in or other sort of back-scratching relationship between parent and bank.

We are aware, through a variety of conversations with industry trade groups and others, that there is a particular sensitivity, say, to allowing security firms to buy thrifts.

I must confess I cannot fully grasp, even after a number of conversations, why they are so much disliked compared to retail stores or others. But nonetheless, we obviously sense that there is strong opposition there.

I think one has to, in spite of that opposition, look at the benefits that could be achieved by, say, having the entrance of Prudential, Equitable, John Hancock, Sears, and a number of people who own securities firms and who have substantial amounts of capital which could be used to bolster the S&L industry. We should really look at those potential entrants in terms of the fact that the benefits far outweigh any possible concerns that couldn't be coped with in terms of their subsidiaries in the brokerage business or in the underwriting business.

To summarize, I cannot find the logic that says securities firms are worse as purchasers than somebody else, but I certainly find the emotion. But I think in spite of that emotion it's well worth considering because there are great bodies of capital out there in insurance companies and others that currently own S&L's, and yet the world hasn't come apart, and they could be major buyers of failing thrifts.

The CHAIRMAN. Well, it may not have any logic, but it's easy for me to tell you after all these years in the trenches why they don't want them in. It's very simple. It's a matter of equity and, look, if you want to be in the banking business, let us in your business. It's just that simple and that's one view I have always shared.

A lot of the securities firms think I'm antisecurities. No, not at all. You either have to stay out of the banking business or you have to let the other side of the equation in. You can't have it both ways and I don't care which side it is coming from, I would take the same position if banks and S&L's wanted to get into the securities business but were saying we will not permit any of them in our business. It is a gigantic double standard that has gone on for years and that is probably one reason that Congress won't deal with it. We simply don't have the courage to say there is a double standard and we're going to solve it one way or another.

There are only two ways to solve it. You either say everybody stay in their own bailiwick or everybody is allowed to cross over and homogenize the process. And that is what is happening in the marketplace, will continue to happen, despite the fact that Congress continues to vacillate and won't make decisions on these issues, whatever those decisions are.

Mr. GOULD. Well, I think, Mr. Chairman, that's exactly the thrust of the Treasury's statement here, that we should open up for the banks the consumer services that currently are only the province of securities firms, and that we should open the door the other way and allow people in so that they can compete on a more equitable basis. In our view, these steps will both help keep the institutions healthy and make available a wide range of services to the community.

The CHAIRMAN. Well, obviously, one of the arguments that is always made for those who wish to limit any expanded services for traditional depository institutions is safety and soundness, but I think it should be evident to most everyone that safety and soundness is a two-edged sword and that by limiting competition you can certainly cause safety and soundness problems as well.

Certainly there are services that banks and savings and loans should not get into. They are too risky and cause safety and soundness problems and some of the critics are correct on certain forms of new services, getting involved in general commerce and a list of things, but on the other hand, would you agree that limitations of competition can also have a very adverse impact on safety and soundness and an impact on the FSLIC and the FDIC because of the lack of opportunity to be profitable?

FAVOR EXPANDED SERVICES FOR EVERYONE

Mr. GOULD. Yes. What we have tried to describe is not a static economy or a static mechanism for delivery of financial services, but rather one that has evolved over the past 20 years or more as a function of the demands of the marketplace. And as long as the demands of the marketplace are there—and we see no evidence of them going away—this evolution will continue. Our basic message is that we don't think we can just fence in traditional institutions in a sphere of activity which once was appropriate—intending no criticism of what once was their purview—but rather that the evolving demands of the marketplace are leaving them behind. If we don't allow them to effectively compete we will end up with a truncated banking system down the road, which in turn will put greater strain and danger onto the federally backed insurance funds.

And that is to be avoided, in our view, by allowing competition, by allowing people to offer services that are natural to their marketplace. If one takes the example of IRA's in banks for small savers, that is an area that I don't think anybody can contest on safety and soundness grounds. Banks have a very natural market to offer for individual retirement accounts, something beyond the interest rate vehicles that they have at the present time. To us there is no safety and soundness issue there; it's a natural evolution, and in our view should be allowed as a service for banks.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

In your statement you make a number of points, including the following as I've gone through it in terms of summaries: you think banking organizations should engage in more services, that the problems of the thrift and the FSLIC should be addressed, and that improvement should be made in the regulators' operational ability to manage failures. Then you conclude—and this is where it starts to get a little hazy for me—by saying that "if legislation is appropriate and opportune, we stand ready to assist in ways large and small"—that's a quote.

I want to nail this down because we may not see you again for awhile and if we're going to act we've got to get going here.

Do you believe that legislation is or is not appropriate in each of these three areas?

Mr. GOULD. Well, I think it's a mixture, Senator. I think in some cases there may be need for specific legislation. I think in some areas legislation or the sense of Congress might aid the regulators in interpreting what they can do by current regulation, a sense that Congress is firmly behind them in areas that are perhaps a little hazy in their minds. In some cases, clearly, legislation is not needed and the regulators can accomplish it under their current powers.

What we really are asking here is for, in some cases, legislation; in other cases, it is a sense that this is the direction Congress wants to see the industry go.

Senator RIEGLE. Is that another way of saying that the administration's official position that there should be a banking bill this year?

Mr. GOULD. It would be our ideal world to have a broad banking bill this year.

Senator RIEGLE. Are we likely then to get a more precise set of recommendations from you at some point that would outline what you think ought to be in it or will the general guidelines you have given us today be the extent of the recommendations you will make to us?

WILLING TO PARTICIPATE IN GREAT SPECIFICITY

Mr. GOULD. No, sir. We would be willing to sit down with this committee and the regulators in great specificity, realizing that in breaking some new ground on existing problems there indeed should be an exchange of ideas as to the most appropriate way to handle things.

Working with the Home Loan Bank System is very important if indeed FSLIC is going to avail itself of their money.

Senator RIEGLE. I think I understand what you're saying. Let me move to a related question. That is, on page 6 you say, "For many people, the problems of the thrifts and FSLIC comprise the most important deposit insurance issue." And I'm wondering—I know that's true for many people, but with specific respect to yourself and the administration, would you today see the FSLIC situation as the most important deposit insurance issue?

Mr. GOULD. In a monetary sense, yes. I think from the statistics we quote here, it is evident that there are more problems to be resolved than FSLIC is currently able to handle with its resources.

And I think we have had a bit of good luck, if you will, by declining interest rates and the continuation of a pretty good economy, and that has resulted in the industry as a whole having record earnings in 1985.

Without predicting interest rates, I think that we must look forward at some point to something that goes the other way, and I think this is the time therefore to get at the problem while the industry is in the aggregate sense healthy. We should address the problem which is clearly there, and in the sense that the problem is there, that makes it a leading issue.

Senator RIEGLE. But does that make it No. 1?

Mr. GOULD. In terms of deposit insurance, yes. I think it represents at this moment of time the single outstanding problem for deposit insurance funds.

Senator RIEGLE. Let me ask you a tax issue. As you know, we are about to get moving with some speed presumably on tax legislation in the Senate. In 1981, Congress adopted three special tax rules for financially troubled thrift institutions to promote their acquisition by healthy institutions, which is part of what you're recommending. Just to recall what they are, one effected assistance payments to a troubled thrift by the Federal Savings and Loan Insurance Corporation are not to be treated as either taxable income or contributions of capital. The second, the merger or acquisition of a troubled thrift is treated as a tax-free reorganization where the Federal Home Loan Bank Board certifies that the thrift is financially troubled. And third, the requirements to avoid limitations on net operating loss carryovers under a tax-free reorganization are considered net when a troubled thrift is involved.

Those three items together, technical as they are, I think have been very important.

Section 804 of the House tax bill, H.R. 3838, would repeal these special rules effective January 1, 1986, and the rationale given is "because they give beneficial treatment to a selected class of beneficiaries."

I'd like to know today whether the administration supports the repeal of these provisions.

Mr. GOULD. Well, if I remember correctly, Senator, the President's proposal had a phase-in with respect to the thrifts out until 1991, and that the House version made it effective January 1, 1986. So the administration's position had been to change the law but over a time period that gave the thrifts a chance to adapt and gave them an opportunity to handle many of the troubled thrifts before the full impact of that tax change.

Senator RIEGLE. Well, we've moved on down the track now so we have the House bill. The House bill incorporates these repeals and I think we need to have a very specific statement from you for the record. I don't mean this minute unless you want to take the time to do it, but I think in very short order we have to have a definitive statement from you on this matter before the wheels begin to turn in the Finance Committee here so we can appropriately express a judgment on it to our Finance Committee colleagues, some of whom serve on this committee, and so that we know precisely where you are.

The FHLBB and FSLIC are expanding staff considerably so as to handle better their supervisory and problem case resolution responsibilities. The FHLBB's budget included 628 staff positions ("full time equivalents") in 1985; the Administration is seeking to increase this number to 862 in 1986 and 965 in 1987. The break out for FSLIC alone is 159 in 1985, 298 in 1986, and 372 in 1987.

Furthermore, during 1985 the FHLBB shifted its examination force (about 750 people) to the 12 FHLBanks, which have mapped out an ambitious growth program for this important function. The establishment of the so-called 406 Corporation, now properly focused in authority, may also help FSLIC to dispose of assets more expeditiously and profitably.

Despite these substantial efforts to expand organizationally, there are limits on FSLIC's capability to increase its case resolution efforts. In setting future targets, we need to be aware of past results: FSLIC resolved 33 cases ($6.5 billion in assets) in 1985; 27 ($6 billion in assets) in 1984; 49 ($16 billion in assets) in 1983; and 74 ($28 billion in assets) in 1982. The larger numbers in earlier years reflect the relatively easier task (and lower cost) of resolving "negative interest rate" spread cases.

C. A Suggested Approach: A Three-Pronged Strategy

We recommend a three-pronged strategy to help the thrift industry and FSLIC.

First, we need to strengthen the thrift industry as a whole. We must set targets and create incentives for the industry to increase its capital. Concurrently, we need to halt the growth of the problem through improved supervision.

Second, we must enhance FSLIC's resources so that it can handle a greater number of insolvent institutions. FSLIC needs additional funds if we wish to make more progress, more quickly. To avoid placing too great a burden on the industry at once, the funds for FSLIC should be a balance of industry assessments and prudent borrowing or investment from the Federal Home Loan Banks. In effect, FSLIC could borrow against its future stream of assessment and investment income to avoid encumbering the industry with a full recapitalization effort immediately.

Third, we can lower the resolution costs that FSLIC and the industry must pay if we manage to increase the demand from acquirers and enhance the franchise value of ailing thrifts. New entrants can also increase the industry's overall capital base and long-term health.

We recognize that interindustry thrift acquisitions are a touchy subject for many parties, especially some segments of the industry that wish to avoid competition. But the acquisition logic is straightforward and undeniable. The problem institutions have created real costs that FSLIC and the industry must bear. Neither the Congress nor the Administration is in the mood to accept a budget-busting bailout, although we can help in other non-expenditure ways. So if the thrift industry wants to cut its costs, it should not close out potential acquirers.

As I noted in the first part of this statement, these new competitors are already pursuing alternatives that will enable them to serve consumers and others. Why not channel this energy and capital to help FSLIC (and the thrift industry) instead of trying to retain the market structure of a much earlier era? Indeed, many thrifts, such as the members of the National Council of Savings Institutions, have recognized and accepted these stark facts. NCSI welcomes increased acquisitions of ailing thrifts by a variety of firms.

We also have had productive discussions with the U.S. League of Savings Institutions. While we may have some differences of opinion, we agree on a great deal. And there's a strong common interest in action now to help thrifts and strengtnen FSLIC.

We acknowledge that the thrift problem will not be solved overnight. But interest rates are down and many in the industry are enjoying exceptional profits. This is the time to move forward vigorously with the elements of this three-part program.

1. Strengthening the Thrift Industry

First, we need to increase the capital base of the industry. This increase can be spurred in part by FHLBB regulations, currently under consideration, to increase minimum net worth requirements over time. (Risk-based capital requirements offer a variation on this theme.)

To comply, some mutual thrifts may need to switch to stock form, because it will prove difficult to build the necessary capital by relying solely on retained earnings. The FHLBB is examining ways to help by easing the conversion process. Furthermore, it is appropriate to consider incentives to raise capital as well as mandates to do so; higher capital levels could be linked to increased business freedom.

Second, the FHLBB should continue its effort to phase out regulatory accounting (RAP). The industry's ability to return to generally accepted accounting principles (GAAP) would be a valuable signal to investors and depositors that this industry will be run soundly.

Third, the FHLBB and the FHLBanks should continue to enhance their efforts to improve supervision. The additional latitude in business activities that thrifts now enjoy must be combined with careful monitoring, especially for thrifts without much of their own equity capital at stake. Active enforcement of rules to limit or monitor the growth of weak and poorly capitalized thrifts should be an adjunct to this supervision. An appropriate system of risk-related insurance premiums may buttress this effort.

Fourth, we need to reconcile states' authority to grant new thrift powers with FSLIC's financial responsibility to pay up if thrifts fail. We believe some proposals go too far in the direction of prohibiting state-authorized activities. We believe a better balance could be achieved by the retention of additional state powers only in holding company subsidiaries (rather than prohibit them) -- if the Bank Board determines this extra protection of FSLIC is necessary. The state institutions could still proceed in new business areas, but they would need to do so with their own capital (through a holding company subsidiary) instead of with FSLIC-insured funds. This capital could include profits "upstreamed" from the thrift subsidiary -- if they are not necessary to meet Bank Board capital standards.

2. Enhancing FSLIC's Resources

FSLIC's estimated income before expenses for 1986 is about $2.6 billion, including a little over $1 billion from another year of the special assessment. There have been numerous suggestions about ways to raise more capital for FSLIC. The proposals include a special one percent recapitalization, an increase in the special assessment, and a merger with the FDIC. We would prefer to avoid these measures for now, if possible. Instead, we believe the current contributions to FSLIC can be combined with carefully evaluated borrowing and investments from the FHLBanks, spaced out over time.

Some members of the industry are seeking to end the special assessment. While we agree that the assessment must remain "special" and impermanent, it is not the right time to scale it back. We can review the need for this extra charge after the FHLBB has had an opportunity to address more problem cases. Indeed, if FSLIC can deal promptly with some of the weakest thrifts, which are often among the most aggressive bidders for "hot" money, the case resolution effort may be able to reduce the industry's cost of obtaining deposits. This cost reduction would in part offset the special assessment. Moreover, new entrants, if permitted, could lower FSLIC's costs and broaden the industry's capital base, thus potentially lessening the burden for existing healthy thrifts.

To date, the assistance of the twelve FHLBanks has remained relatively minor. The FHLBanks are owned by the industry, but linked to the FHLBB in myriad ways. They are well-capitalized institutions (1985 paid-in stock of $8.3 billion and surplus of $1.8 billion) with strong assets and earnings.

The FHLBanks issue consolidated debt, for which they are joint and several obligors, in the private capital markets. In part because of the FHLBanks' ties to the FHLBB, their paper trades as "agency" securities, with borrowing spreads close to Treasury securities.

The Garn-St Germain Act authorized the FHLBB to direct the FHLBanks to lend to FSLIC. There are possible variations on this loan approach, perhaps involving deposits, subordinated debt, and preferred stock. Authorizing legislation may be necessary for investments in FSLIC. Furthermore, any financing "package" must be attentive to the FHLBanks' position in the debt markets and to the operating needs of the thrift industry.

In addition, the FHLBanks could take some pressure off FSLIC by providing their standard advances to troubled thrifts without the FSLIC guarantee the FHLBanks require today. These advances might be a substitute for the "hot" money that finances certain weakened thrifts while FSLIC considers how to handle them. The advances would lower the risk and costs of a thrift on "hold" and ease the deposit bidding wars that hurt local healthy thrifts.

I met last week with the twelve presidents of the FHLBanks to discuss our ideas with them. They gave me some important insights. Most important, the FHLBank presidents are anxious to work with the Congress, the Bank Board, and the Treasury to fashion additional FHLBank support for FSLIC. We, in turn, will seek to arrange a FHLBank financing package that taps the Banks' skills and resources responsibly.

3. Expand the Acquisition Program for Ailing Thrifts

An increased acquisition effort offers one real option for expanding the set of institutions that can bear the cost of the thrift problem. Therefore, it is vital that we reexamine old beliefs about entry into the thrift business.

At a minimum, we must extend the emergency acquisition provisions of the Garn-St Germain Act, which expire April 15. In doing so, the Congress may wish to modify the statutory bidding process. The law now provides a second shot for some losing bidders through an awkward procedure that has prolonged the process and dampened other bidders' interest.

We also urge the Congress and the regulators to look twice before determining that certain classes of bidders, such as securities firms, cannot be accommodated in some fashion. Perhaps certain restrictions on affiliate transactions and conflicts of interest may suffice. In addition, some proposals before the Congress, such as the "tandem" restrictions, make thrift acquisitions exceedingly unattractive; they also strike a blow against consumers by prohibiting cross-marketing and other business connections that improve service and competition.

The regulators can also play an important role. The FHLBB has proposed a regulation that would increase the franchise value of a failing thrift: It would permit an acquiring S&L the right to expand into three additional states. The Bank Board is also taking steps to speed up the acquisition process and to market thrifts more actively.

The Federal Reserve Board has moved cautiously in permitting bank holding companies to acquire ailing thrifts. The FRB's tandem restrictions on BHCs' acquisitions of ailing thrifts are exceedingly stringent. The separation between an acquired thrift and other subsidiaries is much greater than that between the BHC's bank and those subsidiaries. These rules are vestiges of acquisitions during an earlier era when statutory interest rate differentials were in place, and before interstate banking compacts took hold. We surmise that the FRB is in part waiting for signals from Congress with respect to the current usefulness of such restrictions.

Summary on Thrifts

We wish to engage the Congress in this effort to help strengthen thrifts and resolve FSLIC's problems. We value highly your experience and insights. Equally important, we need your help to make real progress with the many players involved. We can make a start alone. But together we can develop a meaningful program that will make a difference.

III. Operational Deposit Insurance Issues

When Professors Milton Friedman and John Kenneth Galbraith are in agreement on an economics issue, I usually find it worthwhile to listen. So it is on deposit insurance. Both

gentlemen have stressed the key systemic protection afforded the nation's financial network by deposit insurance.*/ Moreover, it is important for America's small savers to have at least one totally safe investment.

I stated earlier that over time a deposit insurance system can be only as strong as the industry it stands behind. We are urging the Congress to permit the depository institutions to evolve with their marketplace -- for the sake of the customers they serve and the very health of those financial institutions. In addition, we also must recognize that periods of market adjustment, whether or not we wish it, will result in some institutions failing. It happens in all industries. While we need to avoid substantial costs to the public, the failure of less competitive firms is not an altogether unhealthy sign.

Failures of depositories, however, cause problems for the FDIC and FSLIC. They must manage the failure process so as to minimize disruption of the financial system and the lives of the depositors. I have just discussed such a "failure management" program in the context of FSLIC and the thrifts. Without presaging Chairman Seidman to a great degree, I would like to outline for this Committee some important operational "failure management" issues facing the FDIC. We share Chairman Seidman's interest in these matters and welcome an opportunity to work with this Committee to enhance the FDIC's ability to protect depositors and the financial system.

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*/ Professor Friedman wrote in 1963 in A Monetary History of the United States that:

> Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic and, indeed in our view, the structural change most conducive to monetary stability since state bank note issues were taxed out of existence immediately after the Civil War.

Professor Galbraith explained in 1975 in Money: Whence it Came, Where it Went, that:

> The anarchy of uncontrolled banking [was] brought to an end not by the Federal Reserve System but by the obscure, unprestigious, unwanted Federal Deposit Insurance Corporation .... In American monetary history no legislative action brought such a change as this.

One frequently mentioned operational issue is the unequal treatment accorded large and small banks. The inequality arises in part because the FDIC does not have the tools to treat different size banks alike, while keeping costs and disruptions down. The FDIC needs the authority both to arrange purchase and assumption transactions with greater flexibility, and to ensure that stockholders, managers, and liability holders remain at risk.

For example, the FDIC has sought authority to acquire the voting or common stock of an insured bank in connection with an emergency assistance plan. A floor amendment to the Garn-St Germain Act prohibited such purchases. The FDIC has sought this power for two important reasons: to ensure that the shareholders bear their full loss and to give the FDIC time to operate the bank as a going concern while it examines the portfolio closely and readies the bank for sale. Such an "open bank rescue" helps preserve the bank's value and avoids a "fire sale." To avoid concerns about FDIC ownership of banks, the Congress could impose a reasonable time limit on the FDIC's ownership, perhaps with an extension if the FDIC makes certain certifications about the progress of audits, reorganizations, and marketing plans.

Two other key operational issues for any deposit insurer are the definition of deposit and the delineation of accounts eligible for insurance. Some court decisions have broadened the meaning of deposit to include, for example, letters of credit. We believe it is appropriate for the Congress -- in consultation with the FDIC and the FSLIC -- to define deposits by statute; we have concerns about a broad delegation of this powerful authority to the regulators.

The absence of priorities for creditor claims has at times tied the FDIC's hands (and increased its costs) when it has sought to arrange purchase and assumption transactions. We believe the Congress may wish to establish a depositor preference claim over other general creditors, as some states have done.

Another important "failure management" issue relates to the cost we are willing to force banking customers and the FDIC to bear to preserve historical geographic barriers to competition. Perhaps at one time these barriers had an important local value. But we need to reevaluate their cost today.

The Garn-St Germain Act only permits interstate rescue mergers of "failed" institutions of at least $500 million in assets. The same law permits interstate mergers of "failing" thrifts of any size. The FDIC should not be hamstrung in this fashion, especially if we wish it to: lower resolution costs; seek to maintain service to borrowers, depositors, and the community; and avoid disruptive bank liquidations.

An analogous problem arises in some unit banking states. The Congress should examine whether it is now time to permit the FDIC to allow failing banks to be operated as branches of their acquirers. Otherwise, some small, failing banks in rural communities are more likely to be closed and liquidated. In those exceptional circumstances, should the interests of the local bankers (or their regulators) triumph over those of other people in a small town?

Finally, the FDIC faces an important operational issue of how it will manage the poor quality assets of failed institutions. In the past, the FDIC often kept the poor quality assets after it arranged for another bank to assume the good assets and deposits. This approach has the unfortunate effect of making the FDIC the owner and liquidator of many loans. The FDIC has suggested that it may be time to leave more loans, even poor ones, within the private financial system. This approach has three benefits. It may make it easier for debtors to restructure their loans, it relies on private sector (often local) skills and incentives, and it eases the FDIC's organizational burden.

In summary, we believe there is much that can be done to improve the "failure management" capabilities of the deposit insurance agencies. But many reforms require Congressional action. Some issues will force us to reassess whether long-established barriers now hurt local borrowers and savers more than they protect them. The need is clear. The changes wrought by national, even international, financial markets cannot be disregarded. We have an opportunity to adapt our regulatory systems to them, so that consumers and small savers can be served better. I would like to assist this Committee in meeting the challenge.

IV. Conclusion

We will make our best effort to press forward now on these three consequential topics.

If banking organizations could engage in more services, they could attend much better than they can today to the needs of the public -- consumers, small businesses, state and local governments, America's corporations, and others. Just as important, especially from a safety and soundness point of view, is the exigent need for banking organizations to catch up with the evolution of the market; otherwise, they face economic obsolescence. Their regulation and supervision must adapt, too. It is to all our advantages to think creatively about safeguards for depositories owned by different types of firms, instead of trying to prohibit market and technological changes that we will never control or prevent. Moreover, the nation's consumers and small savers show no evidence of wanting to stop these beneficial changes.

Mr. **Gould**. I would be glad to get that for you very shortly, Senator.

Senator **Riegle**. I think that's important. If you want to go the phaseout route, I think we really need to have a very definitive statement on it.

[The following information was subsequently received for the record:]

TAX RULES FOR THRIFTS

Question. What is the administration's position on the proposed repeal of the special tax rules for acquisitions of financially troubled thrifts?

Answer. Special rules enacted in 1981 permit the acquisition of a financially troubled thrift to qualify as a tax-free reorganization without regard to certain requirements generally applicable in other reorganizations. Qualifying as a tax-free reorganization allows the acquiring corporation to succeed to the tax attributes of the failing thrift. In addition to the special reorganization rules, an exclusion from income is provided for payments by FSLIC in connection with a reorganization.

Section 804 of H.R. 3838 would repeal these special rules effective January 1, 1986. Although the administration agrees that repeal is appropriate because the special rules are a subsidy for FSLIC, the President's tax reform proposals recommended that repeal of these special rules be delayed until January 1, 1991. The delayed effective date was proposed because the thrift industry has not fully recovered from the economic difficulties which prompted Congress to enact the special rules in 1981. A 5-year delay in repeal would permit FSLIC to seek to revise its premium assessment system to charge higher premiums or to charge risk-based premiums. In addition, most of the below-market mortgages currently in thrift portfolios should be repaid by 1991.

We continue to support the 5-year delay in the effective date of these special tax rules as was proposed by the President.

Senator **Riegle**. Am I correct in assuming from the statement today that current administration policy with respect to nonbank banks is that you see no reason to close that loophole?

Mr. **Gould**. We see no reason to close that loophole as a specific isolated issue. We hope and we believe what would be a proper thrust would be to provide the proconsumer benefits of the nonbank bank via the thrift industry by allowing new entrants into the thrift industry and expanding the consumer benefits in that manner.

OPPOSED TO CLOSING NONBANK BANK LOOPHOLE

In the context of a comprehensive banking bill, that is the ideal way we think the world should go. But if you say to me you don't have that option, it's either for or against nonbank banks, my answer is that we think the procompetitive benefits of the nonbank bank are sufficient that we would oppose closing the nonbank bank loophole.

Senator **Riegle**. Well, I think that's a forthcoming answer and I appreciate the clarity with which you give it.

A little later the Comptroller of the Currency is going to be testifying. You may not have had a chance to read his testimony yet. This is a quote from it: "There are few if any activities that cannot be safely combined with banking" which would take the broad view such as I think you express in your remarks.

As a person with a Wall Street background such as you have, are there any areas that make you uncomfortable in terms of the banks moving into new areas? I'm thinking specifically—and I'll give you some to think about—underwriting corporate securities, mortgage-backed securities, revenue bonds, insurance, real estate—is there any place that you would become reluctant to see banks moving into new fields or would you be prepared to see them move into all those fields?

Mr. GOULD. Well, I'm not here today to advocate the total repeal of Glass-Steagall; no, sir. I feel again very much as Treasury has expressed before, that this is an area that you start into—that is, additional services—and see how it goes and you don't just tear down the whole wall of prohibition in one fell swoop.

I have also seen, as I'm sure many others here have, a series of studies which claim to show that indeed a lot of these new activities are less risky than long-term lending in a bank's loan portfolio. And without arguing either side of that, I think the fact is, in our perception, we would feel that mutual funds, mortgage-backed securities, commercial paper, and revenue bonds do not add an element of risk to the banking system which would impinge upon safety and soundness. To the contrary, they could add a diversified income stream for the bank holding companies that would make up for what we perceive basically to be a market share loss on the part of banks in their traditional businesses.

Senator RIEGLE. Well, just one followup. If you don't dismantle Glass-Steagall in one fell swoop but in a series of fell swoops, it seems to me the end result is the same. I guess I'm wondering if you look down the line, are there any residual activities that would make you uneasy about the thought of banks moving into those areas or are you quite prepared to see them in steps move into all the areas?

Mr. GOULD. May I answer that in two ways, Senator? First, one of the reasons I don't advocate a total dismantling of the Glass-Steagall apparatus at this point in time is I think it implies that one's view of the future is too perfect, that you can sit here today and say how something should be in totality. And I think just as a practical matter, experience suggests that maybe you do things step by step and see how it goes. When you take action over time, you have a chance to make a better evaluation than some econometric model we might provide you with today.

The second part of my answer would be, in that context, yes, I would not advocate at this moment of time underwriting equity securities, for example. I would not suggest underwriting—and here definitions change year by year—necessarily what has been termed junk bonds. That's a form of corporate debt but a somewhat different one than traditionally.

So I think, yes, there are pieces of paper which a number of years—several years from now you might consider appropriate. But I think our point of view is let's get started with things which in our view do not impinge upon safety and soundness and then have Congress monitor and the regulators monitor and approach more extensive things such as equity underwriting at some other point of time.

Senator RIEGLE. Thank you for your response.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Secretary, just pursuing that last line of questioning, in your testimony you state that part of the problem facing the thrifts and certain banks result from their failure to adequately value their assets.

ADEQUATELY VALUING ASSETS

Well, that raises the question, if they can't adequately value these assets now, how would you rely upon them to value the underlying assets in these securities issues that you would permit them to underwrite? That gets to the gist of what many of us are concerned about.

Mr. GOULD. Well, I almost think it's easier, Senator, to value something that has a quoted market as opposed to trying to value an illiquid loan or an aspect of the bank's assets which is not a function of a competitive market taking place. If you have revenue bonds or mortgage-backed securities, there is a very liquid and a well-documented valuation mechanism through the market itself.

Senator D'AMATO. Well, again, it seems to me that that kind of runs into conflict with what we see on page 8 when you say that the interest rate spread cases dominated FSLIC's caseload and resolution costs were about 5 percent or less. Then you go on to say, "But the surge in cases involving poor quality assets has increased that percentage considerably."

I would suggest to you that getting back to the proper supervision of the kinds of loans that are being made, the kinds of activities, even given the limited expanded powers that we have allowed, have resulted in increased failures. Those failures have increased not because of the change in the interest rates because interest rates, if anything, have come down but rather because of the poor quality of assets they have invested in.

Now how are we going to be sure that these people who have done an inadequate and poor job we're going to expand their powers and put them into areas that I would suggest are much more dangerous and present much more substantial risk. And that's what this Senator is concerned about.

Mr. GOULD. Well, I think there may be a little confusion, Senator, then on what group of institutions I was addressing when I talked about additional powers. I was not referring to the thrifts. I was in fact referring to the commercial banks. And the part that you are referring to in my written testimony has to do with the thrifts.

Indeed, it is again arguable—and I think too soon for anyone to really try to reach great conclusions—whether the problems of the thrifts that have had expanded powers, through the Garn-St Germain Act in 1982 and indeed on a State basis even beyond that Federal act, of whether it's the new powers or their traditional businesses that have gotten them into quality problems. I think it's too early to tell, but clearly some—at least if you talk to the bank board and the supervisors—will tell you they've gotten in trouble in their old-line business.

Senator D'AMATO. If they've gotten into trouble in the old-line business, I don't understand why they should get into new businesses. Let me ask you, pursuing a line of questioning similar to

Senator Riegle's; I just think there's an awful lot of merit to what he said—at a time when it seems to me that we should be encouraging banks to increase the loss reserves, doesn't the House bill H.R. 3838 penalize them for doing this and aren't they really going in the wrong direction, to put it quite candidly? I can't believe that we are undertaking that. It seems to me that we are running the Congress by way of editorials, that when a group of the Congress increased these reserves they were attacked editorially for bailing out the special interests of the banks. They made a switch within 24 or 48 hours. I think they did the right thing initially and I'm wondering why Treasury doesn't come forward. We've got some deep problems and I see the European banks have been encouraged to increase their loss reserves so that those losses will have much less impact, and it would seem to me we would want to follow that line.

What is the Treasury's position on that?

TREASURY'S VIEWS ON H.R. 3838

Mr. Gould. Well, the Treasury position, as I understand it—and I hastily add, Senator, I am not the Treasury spokesman on taxes—but my understanding of the Treasury position is that we have been listening to a number of suggestions from the banking industry with respect to loan loss reserves, foreign tax credits, and the municipal portfolio interest deductions; that the Treasury's attitude is still the same as has been expressed to the Ways and Means Committee, but that we have had a very open door policy over the last couple months to try to determine from the banking industry the extent to which these items are really punitive.

Now as I'm sure you're aware, we are not saying that if you have a bad loan you can't get a tax benefit. What we are saying is that you have to charge the loan off. You can't put it into an aggregate reserve. We are continuing to run series of numbers. We are continuing to look at the impact of this provision in the context of assuming other aspects of the tax bill affecting banks, which cause their overall rates to rise. Our stated position hasn't changed, but what I'm trying to describe is a condition where we have been very willing to listen to people who have come in and who feel that our loan reserve position is contrary to other national interests.

Senator D'Amato. Well, Mr. Secretary, given the dimensions of the existing problems with regard to international loans, and even some of our domestic energy loans, it seems to me that we had better stop worrying about how people are going to demagogue the issue and paint Congress as being concerned for the big bad banks—and I have had my clashes with them—we'd better be more concerned with providing them a manner in which to adequately write off these loans without doing damage to the financial system and we should begin talking about moving in this direction now rather than wait until we get the crisis—the crisis being triggered by a country or two that says, "We're not going to pay." And that's what I'm somewhat concerned about.

It just seems to me that we're more worried about taking the political heat from the media who might accuse us of favoring big banks when we should encourage them to increase loan loss reserves and thereby perform our duty of ensuring the safety and soundness of the financial system.

You talk about FDIC. If we don't adequately prepare for those contingencies in terms of those bad debts in the reserves, then whatever we're suggesting now is really meaningless and I'd suggest is not going to address the adequacy question.

I would hope we would hear more from Treasury on this.

Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Hecht, I realize you just walked in, but you're on the spot. Do you have any questions you would like to ask?

Senator HECHT. No questions. Thank you, Mr. Chairman.

POSSIBLE FLIGHT OF THRIFTS TO FDIC

The CHAIRMAN. Mr. Secretary, given the percentage of net income that healthy thrifts are paying for deposit insurance premiums, is there any increasing danger of flight from the FSLIC to the FDIC?

Mr. GOULD. Well, there certainly was a fair amount of discussion of it, particularly in the context of the proposed 1-percent assessment that the Bank Board and others talked about last fall. Then the healthy thrifts said, "If you're going to ask us for 1 percent of our assets sent to Washington to help resolve the problem of our bad behaving brethren, we don't like that." Nonetheless, we think that not as many people may wish to change from being a thrift to a bank, to be under FDIC and cause an adverse selection process for FSLIC. I don't think that that will be a major movement if by leaving FSLIC one were also forced to leave the advantages of being a member of the Home Loan Bank System with the home loan bank advances. I think it is one aspect of the problem that Congress should address in a comprehensive bill. In addressing the problem of FSLIC Congress should consider whether or not thrifts should be required to leave the Home Loan Bank System if they are now going to seek FDIC insurance. It really is a lot to ask, I think, that some institutions can now try to have the best of both worlds, not pay dues on the thrift side and yet have the advantage of the thrift bank system.

The CHAIRMAN. What is your opinion of the qualified thrift lender test?

Mr. GOULD. The administration, as in the past, does not oppose the concept of a qualified thrift lender [QTL] test in order to determine whether a savings and loan association receiving statutory advantages can qualify for the unitary thrift holding company exemption.

Under the 1984 Garn bill, which the administration supported, a QTL would be required to maintain 60 percent of its assets in mortgages, mortgage-backed securities, and certain liquidity investments. In return for this limitation: One, the QTL would receive the special statutory advantages accorded S&L's—for example, service corporation investment, Federal Home Loan Bank System membership—and two, the parent companies owning QTL's would not be subject to the activities limitations that apply to bank holding companies.

The administration would not want the QTL test to be so narrow, however, as to discourage nonfinancial institutions from acquiring thrifts or to prevent thrifts from diversifying their services appropriately.

The administration believes that all depository institutions should ultimately be put on an equal competitive footing. Many of the problems currently facing thrifts are largely the result of prior Government attempts to structure an industry by statute in ways that were not economically feasible. We would like all depository institutions eventually to have equal powers and to choose whatever specialization they wish, based on their individual competitive skills and goals.

The CHAIRMAN. Mr. Secretary, I have a lot of additional questions for you, some of them getting rather detailed. Rather than taking your time now, I would like to submit those to you for your response in writing. As I'm sure you're very well aware, this is a very complex subject and we look forward to taking you up on your offer to have a lot more informal discussions as well as possible future hearings to see if we can come up with a legislative proposal in this area.

So I thank you very much for your testimony and your response to our questions.

Mr. GOULD. Thank you.

The CHAIRMAN. Next I'd like to invite Mr. Robert L. Clarke, the Comptroller of the Currency, to be our next witness.

Mr. Clarke, we're happy to have you with us today in your first appearance now that you've been confirmed. If you would like to proceed, please.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY

Mr. CLARKE. Thank you, Mr. Chairman. I'm happy to be here before the committee. I do have an oral presentation I'd like to make, but also would like to have the written comments that were prepared and submitted to you earlier incorporated into the record.

The CHAIRMAN. Your full statement will be printed in the record.

Mr. CLARKE. Thank you.

Mr. Chairman and members of the committee, I am pleased to have the opportunity to appear before you as the committee considers important issues related to Federal deposit insurance, which, it seems to me, must be discussed within the context of the long-term vitality of the industry it insures.

CHANGE IS THE KEY TO MAINTAINING INTEGRITY OF THE SYSTEM

I, my colleagues at the Office of the Comptroller of the Currency, and my fellow Federal regulators are charged with supervision and regulation of the U.S. banking system—and I would emphasize supervision. We take our charge of preserving the integrity of the system—a charge given to us by Congress—very seriously. We appreciate the fact that our banking system is the result of prudence, deliberation, and foresight that has spanned many decades. Yet, we recognize that to preserve the banking system intact does not mean to preserve it unchanged. This distinction is an important one. Indeed, I believe that change is the key to maintaining the integrity of the system in the years and decades to come. Although current problems in the banking industry have been highlighted by severe short-term pressures on a significant segment of the industry, they can, in my judgment, be solved only by fundamental changes that will allow innovation and restructuring to meet the demands of today's marketplace.

How we deal with the short-term problems in banking, particularly the record high level of troubled banks and bank failures, is critical to maintaining public confidence in the banking system. Some changes could be made to our laws and regulations that would address those difficulties. In my statement to this committee next week, I intend to discuss some proposals, related particularly to agricultural banks, that could quickly be implemented. Additionally, there are a number of steps that could be taken to streamline the procedures that a bank must follow to restructure its operations in accordance with its current powers, which I will briefly discuss this morning.

Limiting our efforts, however, to treating only today's symptoms is an inadequate response. The long-term health of the banking industry is a critical public policy concern. As Federal Reserve Board Chairman Paul Volcker noted recently in testimony before this committee and the House Banking Committee, a wide-ranging review of our outmoded banking laws is necessary to ensure the future safety and soundness of the industry. I heartily agree.

Banks, as providers of insured deposits and key participants in the Nation's payment system, play a vital role in our economy. However, the entire financial services industry, of which commercial banks are but one part, is undergoing unprecedented change. If we fail to allow banks to adjust to that change, they will have little choice but to engage in greater risk-taking within the markets available to them. The likely result of that trend, based on our observations, will be reduced profitability. Over time, that will materially reduce the ability of the banking system to compete and deliver products that consumers demand.

Mr. Chairman, as public policymakers, I know we all share a commitment to ensuring that the legal framework governing the financial services marketplace is logical and equitable. But, if we look around us, I believe it is apparent that there is much that needs to be done if we are to modernize the laws governing our financial services industries. Inconsistent and even harmful policies abound. To cite but two examples:

One, banks are prohibited from engaging in relatively low-risk activities such as underwriting the debt securities of highly rated corporate borrowers, but are encouraged to hold in their portfolios often higher risk loans to unrated borrowers.

Two, banks are precluded from participating in the commercial paper market but can assume all of the associated credit risk by issuing standby letters of credit backing commercial paper.

The policies that gave rise to these and a multitude of other inconsistencies are not only difficult to justify, but are also harmful to the banking industry and to the public which it serves.

The basic legal framework governing the financial services industry was established by Congress in the 1930's. While it may have been a reasonable response to the conditions prevailing in the industry at that time, much has changed since then. In fact, in recent years, the changes in the financial services market have been nothing short of revolutionary. Unfortunately for banks and their customers, the legal framework has not kept up with those changes. The result is an industry that is struggling to maintain its ability to compete. Consumers of bank services, both big and small, will be the losers if that struggle is unsuccessful.

TECHNOLOGY IN BANKING

Clearly, one of the most powerful forces causing this change has been the adoption of technological innovations. New technologies have become so common in everyday life that it is sometimes difficult to realize just how recent some innovations are. Many banks' existing delivery systems, developed over a long period characterized by pricing and geographic restrictions, are becoming obsolete.

Second, changing demographics have reshaped the market. Convenience and the availability of one-stop shopping for a wide range of products have become increasingly important and attractive. Also, as the population has aged, innovations in employee benefit plans have emerged. These retirement funds are typically administered by professional money managers who base their investment decisions solely on safety and expected return with little concern for the type of institution in which those funds are placed. Traditional notions of customer loyalty to banks are disappearing.

Economic changes have also altered the market environment. The accelerating inflation of the 1970's and the extraordinarily high and volatile interest rates provided the impetus for the introduction of a number of new financial instruments. Today, fortunately, inflation is relatively low. Prices of some goods have actually fallen, with negative consequences for those who based decisions on the assumption that prices would continue their upward spiral. Despite the strong economic recovery since 1982, however, certain industries and regions continue to exhibit weakness.

I do not want to suggest to this committee that the problems currently confronting the banking industry are all due to inflexible Federal laws and regulations. Many of the industry's problems reflect a willingness of banks to assume large exposures to certain sectors of the economy such as agriculture, energy, and real estate.

More generally, however, I believe that the industry is plagued by its inability to restructure itself in light of the rapidly occurring changes. Restrictions on geographic expansion have limited banks' ability to diversify their loan portfolios and funding sources. Restrictions on allowable activities have prevented U.S. banks from effectively serving changing customer needs, while other financial competitors have made significant inroads into some of their best market segments. Not only do these product limitations inhibit their services to consumers, they have also made it difficult for banks to seek alternative sources of income as their traditional activities have become less profitable.

The consequences of long-standing restrictions have become more severe in recent years as the competitive and economic conditions have evolved. Bank performance has clearly suffered. In 1985, 118 commercial banks failed, a post-depression high, and we expect at least that many to fail in 1986. Earnings for the industry as a whole, relative to the risks it assumes, have been mediocre. In 1984, 10 percent of banks lost money, up from less than 3 percent in 1980. For the 14,200 banks with assets under $1 billion, the average return on assets has fallen in each of the last 5 years. For the largest banks, taken as a group, earnings have been flat for the past 6 years, and several banks have had sizable losses.

Fortunately, these are not irreversible trends, but I am concerned that unless we do something to facilitate banks' adaptation to change, we will end up with a permanently weakened industry.

In the absence of congressional action, the marketplace itself is attempting to respond to change. For banks, however, the opportunities are limited and the routes around the restrictions they face are often circuitous, terribly time consuming and expensive.

A prime example is the phenomenon of nonbank banks, which, in my view, represents a rational market response to the restrictions that have been placed on the banking industry. The only difference between a nonbank bank and a bank is that the nonbank bank, by limiting its services, can be used by bank holding companies as a way around interstate banking restrictions and by other companies as a means of entering the banking business without coming under the restrictions of the Bank Holding Company Act. There is little flexibility under our present statutory scheme, but nonbank banks are certainly a rational market response to the restrictions that have been imposed by that scheme. Wouldn't it be better to change the laws to allow full banking services to be provided to consumers with appropriate safeguards and eliminate the need for nonbank banks?

If banks are not granted more flexibility, the marketplace will continue to find ways around the limitations imposed on banks. Clearly, it would be preferable to move ahead at the Federal level with comprehensive legislation that grants banks in all States the ability to adapt, directly and efficiently, to a changing market.

To enable banks to better serve their customers, legislation is needed that would modernize substantially the laws governing permissible banking activities. Securities brokerage and underwriting, insurance, and real estate brokerage and investment powers would enable banks to offer as broad a menu of products and services as many of their nonbank competitors now offer, thus eliminating substantial inequities that now prevail among financial services providers. Banks would be able to pursue profit opportunities in lines of business that are an integral part of today's financial services marketplace, enabling them to better serve consumers. It would also have the important effect of offering banks alternative investments as well as new avenues of income, thus providing badly needed diversification opportunities.

There are a number of less dramatic steps that the Congress should also take that would enhance banks' ability to restructure their operations in response to changing market conditions. In particular, the burdensome procedures involved in bank mergers, consolidations, and conversions need to be streamlined. Consideration should also be given to expanding the extraordinary acquisition provisions of the Garn-St Germain Depository Institution Act of 1982 to allow an out-of-State holding company that bids to acquire a failed bank to acquire the entire holding company of that bank rather than just an individual banking unit.

It seems to me that the key safety and soundness issue related to banks engaging in new activities is the degree to which a bank's capital or liquidity can be impaired by losses or other adversities associated with the new activity. In making that evaluation, it must be recognized that a multitude of prohibited business activities are less risky than commercial or consumer lending. To the extent that an activity exposes or is perceived to expose a bank to increased risk, there only remains the task of implementing safeguards to limit the exposure of the bank's capital.

Focusing on that issue enables us to move beyond the question of what specific activities should be allowed and prevents the discussion from deteriorating into a debate among special interests. Attention can then be paid to the important public policy question of how the combination of banking and other activities can be conducted, either in a single entity or in an affiliated system, while minimizing the risk to the banking functions. I think we will find that there are a few, if any, activities that cannot safely be combined with banking.

NEED OF COMPREHENSIVE LEGISLATION

Mr. Chairman, I know that you and the members of this committee understand the importance of moving ahead with comprehensive legislation. When I appeared before this committee at my confirmation hearing, you expressed frustration at the difficulty of passing comprehensive banking legislation. I share your frustration but commend your substantial efforts toward achieving such legislation. I stand ready to work with you to continue those efforts.

Despite the severity of the problems that grab the headlines, we cannot allow ourselves to become enmeshed in crisis management or the pursuit of quick fixes. My recommendations are some thoughts about a long-term solution to the industry's problems. They will not immediately restore to health today's problem banks nor will they bring an end to bank failures in the future. As with any other business enterprise, some bank management groups will be unsuccessful in their endeavor. Although short-term measures are certainly worthy of our attention, we must commit ourselves to exploring—and enacting—ways by which banks will be able to compete effectively and diversify prudently. Only then can we be assured that we have done everything possible to promote a strong banking industry that can compete openly in the marketplace and be responsive to the needs of the American public.

I would be pleased to answer any questions you or the committee may have.

[The complete prepared statement follows:]

STATEMENT OF

ROBERT L. CLARKE

COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

March 4, 1986

Mr. Chairman and members of the Committee, I am pleased to have the opportunity to appear before you as the Committee is considering important issues related to federal deposit insurance. As the primary supervisor of the national banking system, I and my colleagues at the Office of the Comptroller of the Currency are concerned, as I know you are, about the banking industry's long-term health. Federal deposit insurance must be discussed, it seems to me, within the context of the vitality of the industry it insures. Although current problems in the banking industry have been highlighted by severe short-term pressures on a significant segment of the industry, they can, in my judgment, be solved only by fundamental changes that will allow innovation and restructuring to meet the demands of today's marketplace.

How we deal with the short-term problems in banking, particularly the record high level of troubled banks and bank failures, is critical to maintaining public confidence in the banking system. Some changes could be made to our laws and regulations that would address those difficulties. I can also assure you that we are making every effort to analyze our examination procedures and standards to make sure that the resources now available to us are being utilized in an efficient and effective manner. In my statement to this Committee next week, I intend to discuss some proposals, related particularly to agricultural banks, that could quickly be implemented. In addition, I would refer you to the July 23, 1985 testimony of our Office before this Committee on the examination and supervisory process. The recommendations provided at that time regarding ways to enhance supervisory tools for dealing with the banking industry's difficulties need continued exploration. Finally, there are a number of steps that could be taken to streamline the procedures that a bank must follow to restructure its operations in accordance with its current powers, which I will briefly discuss this morning.

Limiting our efforts, however, to treating only today's symptoms is an inadequate response. The long-term health of the banking industry is a critical public policy concern. As Federal Reserve Board Chairman Paul Volcker noted recently in testimony before this Committee and the House Banking Committee, a wide-ranging review of our outmoded banking laws is necessary to ensure the future safety and soundness of the industry. I heartily agree.

Banks, as providers of insured deposits and key participants in the nation's payment system, play a vital role in our economy. However, the entire financial services industry, of which commercial banks are but one part, is undergoing unprecedented change. The continued viability of the banking system demands that we allow it to adjust to that change. If we fail to do so, banks will have little choice but to engage in greater risk-taking within the markets available to them. The likely result of that trend, based on our observations, will be reduced profitability. Over time, that will materially reduce the ability of the banking system to compete and deliver products that consumers demand.

Today, I want to discuss with the Committee some ideas which I have about the ability of banks to adapt and to remain effective competitors in a changing marketplace -- a matter that has long-term implications for the safety and soundness of the banking industry. For that discussion, I would like to:

- o review with you changes in the environment faced by banks;

- examine some of the differences between the treatment of banks and other providers of financial services;

- address some of the policy and legal considerations involved in the modernization of financial industry regulation; and

- present recommendations for expanding the competitive opportunities for banks.

Inconsistencies in the Regulation of Financial Services

Mr. Chairman, as public policy makers, I know we all share a commitment to ensuring that the legal framework governing the financial services marketplace is logical and equitable. But, if we look around us, I believe it is apparent that there is much that needs to be done if we are to modernize the laws governing our financial services industries. Inconsistent and even harmful policies abound:

- A manufacturer and its captive finance company (such as General Motors and GMAC) are permitted to offer low-rate loans for its products and no public policy concerns are raised. But the suggestion that banks be permitted to act as real estate brokers and to finance real estate purchases raises the specter of conflicts of interest.

- Banks are prohibited from engaging in relatively low-risk activities such as underwriting the debt securities of highly rated corporate borrowers, but are encouraged to hold in their portfolios often higher risk loans to unrated borrowers.

- Banks are precluded from participating in the commercial paper market but can assume all of the associated credit risk by issuing standby letters of credit backing commercial paper.

- U.S. bank holding companies are permitted to underwrite securities and sell insurance overseas but may not engage in these same activities in the United States.

- Some financial services providers, such as Prudential and American Express, are permitted to combine commercial lending and securities underwriting - banks are not included.

These are but a few of the unfortunate results of our current legal framework. The policies that gave rise to these phenomena are not only difficult to justify, but they are also harmful to the banking industry and to the public which it serves.

Changes in the Financial Services Environment

The basic legal framework governing the financial services industry was established by Congress in the 1930s. While it may have been a reasonable response to the conditions prevailing in the industry at that time, much has changed since then. In fact, in recent years, the changes in the financial services market have been nothing short of revolutionary. Unfortunately for banks and their customers, the legal framework has not kept up with those changes. The result is an industry that is struggling to maintain its ability to compete. Consumers of bank services, both big and small, will be the losers if that struggle is unsuccessful.

Clearly, one of the most powerful forces causing this change has been the adoption of technological innovations. New technologies have become so common in everyday life that it is sometimes difficult to realize just how recent some innovations are: the automatic teller machines that now seem to appear on every corner were a novelty less than 15 years ago; individuals can shift their investments among a variety of money market instruments, equities, and bonds simply by using the telephone; and corporations can control their idle cash balances in a number of different banks, literally on an hourly basis. These, and a myriad of other technological innovations have dramatically changed the kinds of financial services that are demanded by consumers. And these demands have put new pressures on the financial services industry to deliver. Many banks' existing delivery systems, developed over a long period characterized by pricing and geographic restrictions, are becoming obsolete.

Second, changing demographics have reshaped the market. Greater numbers of two-earner families have made convenience and the availability of one-stop shopping for a wide range of products increasingly important and attractive. The growth in home ownership in the post-war period has resulted in a substantial portion of the population whose wealth is concentrated in investment in homes. Banks as well as other lenders have sought ways to enable home owners to tap that wealth, significantly expanding opportunities for providing consumer credit. As the population has aged, innovations in employee benefit plans have emerged. Retirement savings, both through pension plans and individual accounts, have grown -- a healthy development for the economic security of future generations. However, these retirement funds are typically administered by professional money managers who base their investment decisions solely on safety and expected return with little concern for the type of institution in which those funds are placed. Traditional notions of customer loyalty to banks are disappearing.

Changes in rules governing the operation of some markets have been an additional force reshaping the financial services industry. The end of fixed brokerage commissions in 1975, for example, made possible the growth of discount securities brokers. The creation of federal and federally sponsored credit agencies such as GNMA, FHLMC, and FNMA, have dramatically changed the way in which housing finance is provided. State laws are rapidly changing, expanding the opportunities for direct competition among banks, insurance companies, and real estate firms.

Finally, economic changes have altered the market environment. The accelerating inflation of the 1970s and the extraordinarily high and volatile interest rates provided the impetus for the introduction of a number of new financial instruments. Today, fortunately, inflation is relatively low. Prices of some goods have actually fallen, with negative consequences for those who based decisions on the assumption that prices would continue their upward spiral. Despite the strong economic recovery since 1982, certain industries and regions continue to exhibit weakness. These include the well-known problems in agriculture, energy, real estate, and shipping, as well as the difficulties experienced by many less-developed countries. The recent dramatic movements in the price of crude oil have significantly helped some sectors of the economy, but have exacerbated problems in others. The unpredictability of such price movements are but one example of the increased volatility in the domestic and world economies. These conditions have increased the challenges facing all providers of financial services.

Changes in Market Structure

In response to the many changes in technology, demographics, and the economy, the financial services market has undergone significant restructuring. A variety of new financial products and services that are now available were unknown 20 years ago. Adjustable-rate mortages, zero coupon bonds, interest rate swaps, money market mutual funds, open-ended home equity lines of credit -- each has been introduced in response to new consumer demands brought about by the economic environment. Basic banking services have been offered in combination with other financial products so that it is now possible to obtain an array of financial services from a single provider -- and even receive a consolidated financial statement. Consumers have demonstrated their desire for a full line of financial products at a reasonable cost and care little whether they obtain such products from a bank.

For the most part, commercial banks continue to operate within a regulatory framework created over half a century ago. They are limited in their ability to adapt and innovate in response to the changes occurring around them. The result has been that the commercial banks have seen an erosion of their traditional markets and yet have been prohibited from entering new markets. We are left with a world in which companies such as Sears, Merrill Lynch, or Prudential can offer the public virtually every financial service available, but banks remain narrowly confined to products considered "bank-related."

For example, Merrill Lynch's Cash Management Account has in less than nine years attracted more than one million customers and assets in excess of $70 billion. Of that, $19 billion is in Merrill Lynch money market mutual funds. That exceeds the assets at all but the largest 16 commercial banks. Clearly, this innovation, by combining transaction, investment, and credit services in a single product, has successfully filled a previously unmet consumer demand. Why shouldn't banks be able to offer the same combination of services?

Time and again, the banking industry is forced to sit on the sidelines and watch other competitors develop more attractive products and services. In fact, it was not until money market mutual funds had grown to over $230 billion that the insured depository institutions were given authority to offer a similar account. Under existing laws, few commercial banks can hope to offer an array of services like that now provided by the major financial services companies. For instance, Sears, in many of its retail outlets, now offers securities, insurance, real estate, and insured deposit services.

In a number of ways, the market for financial services has become nationwide. For banks, interstate banking is occuring through many avenues, including loan production offices and nationwide solicitations of credit card accounts and deposits. Moreover, 20 states and the District of Columbia have enacted regional interstate banking laws, and 5 have eliminated all geographic barriers to entry. In all, 29 states, including those that permit limited-purpose banks and that have made special provisions for troubled banks, now permit some form of entry by out-of-state banks.

Other financial services providers face no restrictions on where they compete. Everyday, the financial pages of local newspapers advertise mutual fund companies, unit investment trusts, and discount securities brokers with whom customers can transact business by a simple telephone call. The major securities and insurance firms have representatives across the country. Offices can be opened and closed at will. Contrast that flexibility with the difficulty and expense associated with a bank opening a branch across town, much less in another state or across the country. In a number of multistate metropolitan areas, it is virtually impossible for many bank customers to find a bank with branches close to both their work place and residence.

Changing savings patterns have also had an important effect on banks, significantly raising their cost of funds. In the 1970s, as Regulation Q interest rate ceilings resulted in low real rates of returns on accounts at banks, savers moved their funds to financial instruments that paid market returns. The subsequent removal, beginning in 1978, of almost all interest rate ceilings has enabled banks again to compete aggressively for savings deposits. The composition of bank deposits changed fundamentally, however, and, as a result, relative costs have soared. In 1970, nearly 98 percent of the liabilities of banks with less than $1 billion in assets were in demand deposits or other accounts subject to a fixed-rate ceiling. By 1980, the figure had fallen to 64 percent, and in 1984, it was less than 18 percent.

At the same time, banks have lost an important share of their traditional lending markets. Nowhere is this more evident than in the market for commercial credit. In 1965, commercial bank lending accounted for more than 85 percent of short-term credit of domestic corporations. By 1975, the share was 75 percent, and in 1984 was less than 60 percent.

Much of this market share was lost to the commercial paper market. From 1975 to 1984, commercial paper outstanding grew at an average annual rate of 22 percent. Over the same period, bank loans grew at a 12 percent annual rate. Commercial banks are increasingly less competitive in providing top quality U.S. corporations with short-term credit -- a product that was the core of commercial banking in the 1930s when the present statutory structure was established. The ability of commercial banks to retain this business by placing the commercial paper of traditional customers with investors has been recently thrown into question by a federal court, which found this activity to be illegal in the case of one state bank.

Similarly, competitive pressures are extending beyond national boundaries. The financial services market is becoming global in scope. Foreign banks, many of which operate with lower capital ratios, have aggressively sought lending opportunities in the U.S. and have been willing to trade thinner margins for increased market share. As of mid-year 1985, the U.S. banking offices of foreign institutions (including U.S. banks owned by foreign firms) held a 22 percent share of the U.S. business lending market. Even more significantly, from June 1984 to June 1985, business loans at domestic banks rose by only 5 percent; in contrast, over the same period, business loans at U.S. banking offices of foreign institutions rose by 14 percent. The net result of these developments has been an erosion of national boundaries as barriers to competition.

The Need for Banks to Adapt

I do not want to suggest to this Committee that the problems currently confronting the banking industry are all due to inflexible federal laws and regulations. Many of the industry's problems reflect a willingness of banks to assume large exposures to certain sectors of the economy such as agriculture, energy, and real estate. Some of these decisions were undoubtedly dictated by market loan demand, but the fact remains that portfolio concentrations reached unhealthy proportions. Notably, many banks suffering from concentrations of credit to currently weak economic sectors are located in states where statewide and interstate banking powers have been limited. As a result, individual banks in some of these states have been limited in the available sources of loan demand, making them extremely vulnerable to changes in local economic conditions. A small bank with a single office in a small agricultural community, for example, has much more limited lending options than does a bank that is part of a statewide or regional holding company or branch system.

Just as important, a number of banks in these states extended loans on the assumption of continued high inflation, particularly with respect to commodity and land prices. In hindsight, the dependence placed on steadily appreciating collateral values and the lack of attention to the borrower's fundamental earnings capability reflected poor credit judgment. While it is debatable whether anyone could have anticipated the sharp decline in prices that has occurred, it is clear that many other banks located in these same states exercised greater restraint in structuring their credits and avoided the heavy concentrations of credit.

There are some things that the industry can do now to help itself. For example, banks should be more aggressive in establishing correspondent bank networks or other relationships that would enable greater diversification of assets. Banks should also encourage states to reconsider the wisdom of existing branching and interstate entry prohibitions, especially under emergency conditions. Bankers' banks, organized in regions where efficiencies can be realized, should be considered as catalysts for independent bank diversification and expansion.

More generally, however, I believe that many of the banking industry's problems are a consequence of its inability to restructure itself in light of the rapidly occurring changes. Restrictions on geographic expansion have limited banks' ability to diversify their loan portfolios and funding sources. Restrictions on allowable activities have prevented U.S. banks from effectively serving changing customer needs, while other financial competitors have made significant inroads into some of their best market segments. Not only do these product limitations inhibit their services to consumers, they have also made it difficult for banks to seek alternative sources of income as their traditional activities have become less profitable. The result has too often been a reliance on more risky lending or concentrations of credits as banks have sought to maintain an acceptable level of profitability.

The consequences of long-standing restrictions have become more severe in recent years as the competitive and economic conditions have evolved. Bank performance has clearly suffered. In 1985, 118 commercial banks failed, a post-Depression high, and we expect at least that many to fail in 1986. Earnings for the industry as a whole, relative to the risks it assumes, have been mediocre. In 1984, 10 percent of banks lost money, up from less than 3 percent in 1980. For the 14,200 banks with assets under $1 billion, the average return on assets has fallen in each of the last five years. For the largest banks, taken as a group, earnings have been flat for the past six years, and several banks have had sizable losses.

Fortunately, these are not irreversible trends, but I am concerned that unless we do something to facilitate banks' adaptation to change, we will end up with a permanently weakened industry. My knowledge of the legal framework convinces me that there is much that can be done.

The Need for Federal Action

Banks throughout the country -- both large and small -- are asking for the help of their regulators and the Congress to enable them to better serve their customers. Sometimes the banks do not speak with one voice because of their different sizes and the nature of the markets they serve. Nevertheless they will all benefit from a healthy banking industry.

But in the absence of Congressional action, the marketplace itself is attempting to respond to these changes. For banks, however, the opportunities are limited and the routes around the restrictions they face are often circuitous.

A prime example is the phenomenon of nonbank banks. The term nonbank bank is actually a misnomer because these entities are banks. They receive bank charters either from the state in which they are incorporated or from the OCC. They are capitalized in accordance with regulatory standards. They are insured by the FDIC and are examined and supervised as any other bank by the primary state or federal agency. The only difference between a nonbank bank and a bank is that the nonbank bank, by limiting its services, can be used by bank holding companies as a way around interstate banking restrictions and by other companies as a means of entering the banking business without coming under the restrictions of the Bank Holding Company Act.

The banking industry has gained less from nonbank banks than have other financial services companies. Nonbank banks do enable bank holding companies to expand across state lines, but the nonbank bank is by its nature considerably more limited in the services it can provide than a full-service bank. Reliance on the nonbank bank as a means of avoiding geographic restrictions is an inefficient mechanism that will ultimately raise the cost of banking services to the public.

On the other hand, when other companies acquire nonbank banks, they gain direct access to the payment system and the ability to gather federally insured deposits. Moreover, there are generally no restrictions on the other activities of the parent.

Although it is a limited vehicle for exercising greater flexibility, the nonbank bank is available to be used under our present statutory scheme, and its use by banking and other companies is a rational market response to the restrictions that have been placed on the banking industry. I expect the growth

The **Chairman**. Thank you very much, Mr. Clarke. We appreciate your testimony.

I'm going to turn to Senator Riegle first. I've got an important telephone call I need to make, so I didn't want you to think I'm running out on you permanently, just briefly. I will be back. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman. I'll keep an eye on things while you're gone. Maybe we'll get the nonbank bank loophole plugged, but I doubt it.

Mr. Clarke, it's nice to see you today. It's clear from your statement on page 19 where you say that you believe "it would be preferable to move ahead at the Federal level with comprehensive legislation," so that is your position. But I'm wondering if, for whatever reasons, we find ourselves unable to move a comprehensive banking bill through the Congress this year, what limited or narrow legislation do you think should be given priority?

Mr. **Clarke**. Senator, I really have not given a whole lot of thought to narrow legislation because I've just maintained the hope that we would be able to come forth with an acceptable comprehensive bill and I would really hate to see it picked apart and done bit by bit.

Senator **Riegle**. Well, I understand that.

STREAMLINE THE NATIONAL BANK ACT

Mr. **Clarke**. One comment I would make is that irrespective of anything that may be done regarding a long-term solution of the problem, I certainly would hope that some of the streamlining kinds of amendments to the National Bank Act that we would propose could be adopted.

Senator **Riegle**. If you had to go with a short list, would that be on the short list?

Mr. **Clarke**. That could certainly be done outside the context of longer range solutions.

Senator **Riegle**. As you know, we don't yet have an administration recommendation. You heard the testimony before you which was I think somewhat general in nature and we may get from that to a specific proposal, but we do have tax reform and the budget problems with Gramm-Rudman and the space shuttle to sort through and we've got a lot of things on the table at the moment and we have had other things that have kept us from getting a comprehensive banking bill in the past and we may or may not get one this year. But I want to press you a little harder.

If we're not able to get one, is there anything else that you think is urgent and ought to go on a short list for consideration if we have to go with a narrower bill rather than a broad one?

Mr. **Clarke**. Also on that list would be items you will hear more about when Chairman Seidman testifies, changes that would enable bank supervisors to deal more effectively with troubled banks. I mentioned one of these this morning—amending the current statute to allow troubled or failed bank holding companies to be acquired instead of just the subsidiary bank.

Senator **Riegle**. Anything else?

Mr. **Clarke**. Not that I would——

Senator RIEGLE. Think of immediately?

Mr. CLARKE [continuing]. Not that I would advance at this point.

Senator RIEGLE. I sense from the tone of your testimony that unless closing the nonbank bank loophole is combined with a more comprehensive approach that you would not then favor closing the nonbank bank loophole. Am I correct in reading that meaning into your comments?

Mr. CLARKE. I would hate to see it done as a discrete measure. I hope it was clear from my statement that I think that the use of the nonbank bank as a means of expanding either geographically or by nonbanking related businesses is not the most efficient way to accomplish these goals. I would really hope that the need for the nonbank bank could ultimately be alleviated by taking a more comprehensive approach.

Senator RIEGLE. But if we don't have the comprehensive bill, then you would be for maintaining the so-called nonbank bank loophole?

Mr. CLARKE. I think I would, yes.

Senator RIEGLE. Now that to me is the striking thing that I've heard today now from you and Mr. Gould, and I detect in that some change in position—not that the administration hasn't argued for a comprehensive bill for a period of time, it has, but it's also argued for closing the nonbank bank loophole even if that were in a narrower bill. Now I detect a change in position on both of you and what it makes me think is that where the nonbank bank has been used sort of as a back door route by people who have been moving in that direction that if this becomes in a sense an acceptable policy option, absent comprehensive banking legislation, it's like turning the back door into the front door. It sounds to me like that may be what's happening here.

Would I be correct in inferring that?

Mr. CLARKE. First of all, I would not say that it reflects a change of position, at least on my part. When I was up here for my confirmation hearing, I made the statement that I did not favor banking by loophole but felt that as Comptroller I would be required to approve a nonbank bank charter if the applicant met all the requirements. I still believe, as I've said this morning, that nonbank banks are not the best way to go, but they do exist, and I think that the market has tried to make use of them to the extent possible.

NONBANK BANK CHARTER APPLICATIONS

It also needs to be pointed out that we are not in a position at this point to approve any nonbank bank charter applications because the Office is still under an injunction in the Florida court action that prohibits us from granting final approval to any nonbank charters. It's our judgment that it's going to be a number of months down the road before that injunction is lifted.

Senator RIEGLE. Assuming it were to be lifted, in the absence of comprehensive legislation, would it be proper then for us to assume that you would begin to approve nonbank bank applications?

Mr. CLARKE. That's correct. I think we would have no choice.

Senator RIEGLE. And could you give me some sense for what kind of criteria you would use in that situation in evaluating the application. You have a number now and I would think you would have a good deal more maybe after today, but certainly if the injunction comes off. So how would you go about assessing those or would you basically feel that any qualified application would have to be approved?

Mr. **Clarke**. Because a nonbank bank really is a bank and because an applicant applies for one in the same manner as for a bank but elects not to provide all the services that a normal bank would provide, the same standards are applicable to chartering a nonbank bank as are currently applicable to chartering a full service bank.

Senator **Riegle**. So would that mean, just to give us a sense for the volume of the number of applications that are there now and what you might judge would come along in a favorable environment to approving the applications in the absence of the injunction, would we be likely to see a very large number of applications that would otherwise meet the test and therefore get in effect almost an automatic approval?

Mr. **Clarke**. That's a very interesting question. I asked yesterday afternoon as I was preparing for this hearing how many applications had been filed with our Office since the *Dimension* case was decided by the Supreme Court. I was told that there were two.

Senator **Riegle**. Two?

Mr. **Clarke**. There doesn't seem to be a very large groundswell of interest in nonbank banks, at least in light of the *Dimension* decision.

Senator **Riegle**. Well, the phone may start ringing I think after today's testimony. How many before that? Were there others backed up in the pipeline prior to those?

Mr. **Clarke**. Before I answer that, it seems a bigger deal is being made out of the statements this morning regarding nonbank banks than should be. I've maintained from the beginning that for the nonbank bank issue to be resolved by the courts, clearly the standards have to be there for approving nonbank bank charters. Until something is done to change that, I don't think that I, as a chartering official, have any choice but to approve them for qualified applicants. That's been my position from the beginning.

Senator **Riegle**. I understand that and you're still relatively new to the job and so I'm not suggesting that that reflects a change in your position from 1 year ago because you weren't in the job 1 year ago, but I would say from the point of view of what I feel I'm hearing from the administration, if you will, or from the executive agency testimony here, is that if we don't get a comprehensive bill that resolves a lot of these outstanding issues, that the nonbank bank route is seen as a way to, in effect, go ahead and accomplish some of the same purpose and you state it slightly differently but you feel you're under a legal mandate to approve qualified applications, absent an injunction, but in the past the administration I have felt has taken the view that they thought this was not a very good route to go and that the nonbank bank loophole ought to be closed and that they would like other things in addition to that, but I'm hearing a change today.

And when I hear from two witnesses back-to-back saying in effect the same thing, it sort of multiplies the effect of what I feel I'm hearing and I think it will be seen as a change in signal.

Now I don't know if you want to comment further on that or not. I'm just giving you what I think the weight of the testimony we heard now from two witnesses seems to add up to.

Mr. CLARKE. My only comment would be that it really doesn't reflect a change in my position.

Senator RIEGLE. Paul Volcker, as you probably know, has felt quite strongly and continues to insofar as I know that we ought to plug the nonbank bank loophole, regardless of whether or not we get a comprehensive bill. So we have other observers of weight who are on the other side of this issue. I gather you know that.

Mr. CLARKE. Yes, sir.

Senator RIEGLE. That makes it a little difficult for us to sort of sort out that difference of opinion when you get a major regulator, if you will, and the Chairman of the Fed feeling some real apprehension about it and feeling it ought to be plugged and now two successive witnesses coming from another direction saying that not only does it not have to be plugged but it may be the route through which a lot more is done.

Mr. CLARKE. I'm not saying that it shouldn't be plugged. It should just be done in the context of a comprehensive reevaluation of where we are in the financial services industry.

Senator RIEGLE. Let me move to a different area and that most of our discussion today has focused on. The long-term issues facing the industry and where we draw the lines. We have only had a few passing references to short-term problems of banking and I'm wondering—the record high level of troubled banks and bank failures, are they caused in your view by restrictions on banks that keep them from getting into new fields like insurance, real estate, and securities activities? Is that what's caused the big uptake in bank failures in your view?

BANK FAILURES

Mr. CLARKE. As I said in my statement, I do not want to lay the blame for bank failures and problems that banks are experiencing solely on what I consider to be outmoded laws and regulations. I think that some of the problems that have given rise to the increasing number of bank failures stem from bad management, bad decisions, and in some cases an economy in a particular area that has simply gotten away from the lender, that's changed so dramatically that conditions present at the time the loans were made simply don't exist today. So it's a variety of causes. I do think, though, that if some of the institutions had been able to expand into other areas and diversify, they might have been able to keep their capital at a higher level and could have avoided insolvency.

Senator RIEGLE. Just one related thing and then my time will have expired, but in 1985 there were 118 commercial banks that failed, as you know, and apparently we will have at least that many fail this year. Is that your—you're nodding?

Mr. CLARKE. That's our projection.

Senator RIEGLE. What have we learned from these failures? I'm wondering what regulatory changes, if any, you think we need regarding your examination and supervision functions or does this not have a bearing in that area insofar as you can tell at this point?

Mr. CLARKE. I believe the industry has developed an increasing awareness of the need for careful credit evaluation, for avoiding concentrations in particular industries and to particular borrowers, and for internal operating systems than perhaps they had before.

I keep maintaining that it's really the industry that needs to reach these conclusions and in a sense regulate itself. If the regulators went away, the banking industry would still be there, the shareholders would still have their capital at risk, the managers would still have their jobs, and in many cases their capital at risk because they own a substantial portion of the bank, and banks would still need to keep improving their management techniques and their internal operating standards. I see that happening. I think that is a lesson that has been learned from the large number of failures.

Senator RIEGLE. No lessons in terms of how we might be supervising better to try to head off some of these bad practices and these failures that are mounting to such high levels?

Mr. CLARKE. We are continually evaluating our examination and supervision techniques to try to come up with ways to avoid problem banks. We are currently making extensive use of data processing equipment which attempts to identify signs of trouble at an earlier stage.

Senator RIEGLE. My time is up, Mr. Chairman.

Mr. CLARKE. Senator, one last comment. I have just been handed a note by someone who's been around a lot longer than I have that it is his understanding the administration has never been for a bullet loophole closure on nonbank banks.

Senator RIEGLE. We'll get into that. I want to sort of go into a second round with you after the chairman finishes. That's not quite the point I was making.

The CHAIRMAN. Well, let me just make a comment on that. I was not here for the whole discussion, but I have been rather involved in this and my position has always been that we should close the nonbank bank loophole but as a part of a broad comprehensive bill. That was true in the Competitive Equity Act of 1984 which passed the Senate 89 to 5. There was a tight nonbank bank loophole closure in that bill as well as the South Dakota loophole closure, and my position has consistently been that we can always close loopholes. We could do that quickly, could have done it a long time ago, but I was unwilling to do that, and at no time when Secretary Regan was there during the last 5 years has the administration ever done anything but back me in that position. Never have I heard them say that they were willing to go for a nonbank bank loophole closure by itself, but as part of a comprehensive bill they would. And believe me, I've had extensive discussions, as Senator Riegle knows, being the ranking minority member for a while and helping me back with Garn-St Germain. So it isn't my position to speak for the administration other than my conversations with them and I know of no time they have ever backed away from that.

in nonbank banks to continue as long as the banking restrictions that gave rise to them remain.

If banks are not granted more flexibility, the marketplace will continue to find ways around the limitations imposed on banks. Clearly, it would be preferable to move ahead at the federal level with comprehensive legislation that grants banks in all states the ability to adapt, directly and efficiently, to a changing market.

Expanded Bank Activities

To enable banks to better serve their customers, legislation is needed that would modernize substantially the laws governing permissible banking activities. Securities brokerage and underwriting, insurance, and real estate brokerage and investment powers would enable banks to offer as broad a menu of products and services as many of their nonbank competitors now offer, thus eliminating substantial inequities that now prevail among financial services providers. Banks would be able to pursue profit opportunities in lines of business that are an integral part of today's financial services marketplace, enabling them to better serve consumers. It would also have the important effect of offering banks alternative investments as well as new avenues of income, thus providing needed diversification opportunities.

Streamlining

There are a number of less dramatic steps that the Congress should also take that would enhance banks' ability to restructure their operations in response to changing market conditions. In particular, the burdensome procedures involved in bank mergers, consolidations, and conversions need to be streamlined. For example, the complex "phantom bank" merger procedures should be replaced with simplified statutory reorganization procedures for national banks. I also favor the simplification and clarification of arrangements to ensure the rights of dissenting shareholders in national bank mergers and reorganizations, irrespective of the form in which the transaction is accomplished, and elimination of numerous archaic and burdensome statutory requirements pertaining to the organization and corporate structure of national banks. Consideration should also be given to expanding the extraordinary acquisition provisions of the Garn/St Germain Depository Institution Act of 1982 to allow an out-of-state holding company that bids to acquire a failed bank to acquire the entire holding company of that bank.

Concerns About Greater Bank Flexibility

I am aware of a variety of concerns about expanding the range of permitted bank activities, including those that there would be problems of conflicts of interest and that concentrations of economic power could develop. These concerns are often used by special interest groups as support for continued restriction of competition. Where the concerns are substantive, I believe they can be addressed. The securities laws and regulations, the federal antitrust statutes, and our own prohibitions on transactions with affiliates, provide ample precedent for treating conflicts of interest through prohibitions against and penalties for conducting specific practices and through requirements for pertinent and timely disclosure. In my experience, markets without arbitrary barriers to entry are rarely characterized by unacceptable concentrations of power. The removal of current barriers to market entry faced by banks offers the surest guarantee of continued strong competitive practices in the financial services marketplace. And, in any event, mechanisms are or can be put in place, if necessary, to control undue concentration.

A more troublesome concern, in my opinion, is the belief that some of the activities proposed for banks are unacceptably risky. Because banks' ability to accept federally insured deposits and to provide access to the payments system makes them special, the argument goes, they cannot be allowed to take on additional risks, and, therefore, should be prohibited from conducting new activities.

I do not want to suggest that this concern is unimportant. In fact, as the primary supervisor of national banks, I have a keen sense of responsibility to see that these banks are operated in a safe and sound manner. But I do not believe that the way to achieve this is by keeping banks in a legal straitjacket. The long-term safety and soundness of the banking industry demands that it be allowed to expand the range of services that it can deliver to its customers, both in response to market demand and to remain profitable. I believe that the concerns that have been raised are manageable if we craft legislation outlining the manner in which commercial banks can conduct a broader range of activities.

The key safety and soundness issue related to banks engaging in new activities is the degree to which a bank's capital.or liquidity can be impaired by losses or other adversities associated with the new activity. In making that evaluation, it must be recognized that a multitude of prohibited business activities are less risky than commercial or consumer lending. To the extent that an activity exposes or is perceived to expose a bank to increased risk, there only remains the task of implementing safeguards to limit the exposure of the bank's capital.

Focusing on that issue enables us to move beyond the question of what specific activities should be allowed and prevents the discussion from deteriorating into a debate among special interests. Attention can then be paid to the important public policy question of how the combination of banking and activities can be conducted either in a single entity or in an affiliated system while minimizing the risk to the banking functions -- participation in the payment system and accepting federally insured deposits.

In addressing that question, it is important to note that there are three principal ways in which losses from additional activities could adversely affect the banking function. The first and most obvious is where a loss involves an explicit legal liability for the bank. Second, management could make a decision that the general interests of the overall organization would be served by the bank assuming a liability. An example of this would be when a loss is incurred by a subsidiary, and bank management determines that the bank will absorb the loss in order to prevent harm to the bank's name and reputation, even though there may be no legal liability to do so. And third, the public could perceive that losses incurred elsewhere in the organization reflect the condition of the bank, and, therefore, withdraw or withhold funds from the bank.

A number of ways of insulating the bank from these adverse effects have been suggested, and all deserve consideration. One is some form of separation of the activity from the banking function. In addition, explicit controls could be placed on the relationships and transactions among banks and their affiliates. For example, requiring that the activities be conducted in a separately capitalized subsidiary, of either the bank or a holding company, would serve to protect the bank. It could be mandated that a bank supply capital to the subsidiary only to the extent that the bank has capital in excess of the supervisory minimums. If no excess capital were available, the subsidiary would have to attract external capital.

By placing some activities in subsidiaries, such subsidiaries could be run with less capital than that required of the bank. This would better enable them to market products competitively. These activities would be conducted subject only to such regulation and supervision that would exist if the subsidiaries were unrelated to a bank. For example, securities affiliates would be subject to the requirements of the SEC, and insurance affiliates would be overseen by state supervisory agencies. At the same time, the bank would remain subject to the oversight of its primary supervisory agency with all of the attendant capital requirements and restrictions on transactions with affiliates.

There are many other options for controlling banks' exposure from expanded activities that need to be explored. The point I would emphasize is that our efforts should be directed at how to structure the new activities so as to allow flexibility and still protect the bank -- not debating which activities should be permitted. I think we will find that there are few, if any, activities that cannot safely be combined with banking.

Conclusion

Mr. Chairman, I know that you and the members of this Committee understand the importance of moving ahead with comprehensive legislation. Your substantial efforts toward achieving such legislation are to be commended. I stand ready to work with you to continue these efforts.

Despite the severity of the problems that grab the headlines, we cannot allow ourselves to become enmeshed in crisis management or the pursuit of quick fixes. My recommendations represent a long-term solution to the industry's problems. They will not immediately restore to health individual banks that today have problems, nor will they spell an end to bank failure in the future. Although short-term measures are certainly worthy of our attention, we must commit ourselves to exploring -- and enacting -- ways by which banks will be able to compete effectively and diversify prudently. Only then can we be assured that we have done everything possible to engender a strong banking industry that is responsive to the needs of the American public.

If they did, they kept it from me because I would have been all over them if they had wanted to go for a simple closure. Moreover, that has been one of the disputes between the Senate and the House. The House has always been willing to go for a simple loophole closure and Secretary Regan certainly always backed me in opposing that particular position.

Senator RIEGLE. Mr. Chairman, would you just yield briefly on that?

The CHAIRMAN. Certainly.

Senator RIEGLE. I thank you for doing so. I think the change that I'm detecting today is that I think I'm hearing something new being said and that is, I think the administration saying that if comprehensive legislation does not pass, for whatever the reasons, which is obviously what they would like to see is the comprehensive legislation passed, but if it doesn't pass, I'm detecting a sense that they would intend to use the nonbank bank loophole, if you will, as a means to go ahead and accomplish some of the things that they otherwise would prefer to accomplish through a comprehensive bill, but absent that, that rather than holding back on the use of the nonbank bank loophole that maybe that will become a very busy thoroughfare in effect to accomplish in a different way what they think needs to happen. And that, to me, is new. I think I'm hearing that put in a more forceful and affirmative way today by two witnesses than I recall hearing before. That's really my point.

INJUNCTION STILL STANDING

The CHAIRMAN. Well, first of all, you've got a court decision. People's worry about the nonbank bank loophole right now is even with the decision as far as the Fed, the ability to regulate. I don't fault or disagree with that decision, but there's still a moratorium or prohibition on the explosion of nonbank banks by the court and until such time as that is clarified at a higher court level, there is no concern for a vast expansion or approval of nonbank banks. That's your understanding and you don't have the ability to approve nonbank banks at this time, do you?

Mr. CLARKE. No, sir.

The CHAIRMAN. So it's academic and if and when that court is either affirmed or overturned or whatever it is, then obviously we're going to have to pin people down and find out if there is some change of opinion.

I just wanted, from a practical standpoint, to make certain that everybody knows that the recent court decision was interpreted by many as being far, far broader than it was; it was in reality a very narrow decision concerning the Fed's ability to regulate nonbank banks.

Mr. CLARKE. It is important, Mr. Chairman, to note that while we are still prohibited by the court decision from chartering nonbank banks, bank holding companies or nonbanking companies can acquire existing banks.

The CHAIRMAN. That's correct.

Mr. CLARKE. And convert them to nonbank banks.

The CHAIRMAN. That's correct.

We have been told that banks' traditional profit formulas are becoming much less tenable and yet at the same time that we hear that reported bank profits have been on the rise. How do you reconcile the differences in the testimony that we get? On the one hand, banks are being squeezed; on the other hand, profits are rising and some of them are doing very, very well.

Mr. CLARKE. A very valid question to which there are several answers. I think the trend line will show that over time the return on assets and return on equity of most banks is trending downward even though the banks may on a quarter-by-quarter basis in the last 12 months have reported some very good profits. The other thing that has to be examined is the quality of those earnings, where the banks are having to go to get their earnings, what kind of risks they're having to take to achieve those earnings, and whether the pressures that they are under to come up with those levels of earnings are leading them in directions that we, as bank supervisors, would prefer they not be headed.

The CHAIRMAN. You point out the banks have lost market share, particularly in their traditional lending market, and more specifically in the market for commercial credit. In light of the recent district court case disallowing Bankers Trust the authority to deal in commercial paper, should Congress be addressing the commercial paper issue?

Mr. CLARKE. I certainly think so. That would be high on the list of things that I believe should be acceptable activities for banks to be involved in.

The CHAIRMAN. Well, again, that was another issue that was in the bill that passed the Senate 1½ years ago. If we do not address that and on appeal the district court is upheld, what effect on banks' market share do you think that is going to have?

Mr. CLARKE. I think it's going to have a significant effect. I can't quote you a number, but I think it's going to be very devastating. Of course, the question then would become what happens to banks other than Bankers Trust? Until the court of appeals lifted the injunction, they were the only bank that was judicially barred from engaging in commercial paper activity.

The CHAIRMAN. It's rather interesting too that the judge required them to cease that activity as of last Friday. Usually the decision is stayed pending appeal.

Mr. CLARKE. That has been lifted.

The CHAIRMAN. Was that lifted?

Mr. CLARKE. The court of appeals lifted that stay, so they are still in business until the appeal is resolved.

The CHAIRMAN. Did the judge change her mind or did a higher court change it for her?

Mr. CLARKE. A higher court changed it for her.

The CHAIRMAN. Thank goodness for higher courts. We used to have a judge like that in Utah who before I could get rid of him the Lord took care of him for us. He used to get overruled 84 percent of the time on appeal at the Tenth Circuit Court level. It didn't bother him a bit. He continued to rule regardless of what the circuit court thought 84 percent of the time. That was rather a remarkable record of being overturned. It didn't even embarrass him either.

As of midyear 1985, U.S. banking offices of foreign institutions held a 22-percent share of U.S. business lending market. Now we've been holding hearings on the foreign capital markets, internationalization of capital markets, Eurobond market just in the last week or so. What is your opinion? Should we attempt to do something about that? Should we increase regulation on foreign institutions or do you think we should free up American institutions to be able to compete more in that international marketplace?

ALLOW FREE MARKET TO OPERATE

Mr. **Clarke**. I would prefer the latter solution. It seems to me that it becomes very difficult to regulate a lot of the activities of foreign institutions, even if you wanted to. It would be much preferable to allow a free market to operate, to allow our institutions to compete more effectively with them.

The **Chairman**. In 1956 Congress delegated to the States the responsibility to decide the future of interstate banking and, as you very well know, States are making rapid strides in that area. The State of Utah recently passed unanimously in both the house and the senate and it was signed by the Governor, a bill to allow troubled institutions to be purchased by out-of-State banks—that didn't surprise me as much as the fact there was a 2-year trigger. On January 1, 1988, any institutions can come into the State. Citicorp came in instantly and the troubled institution now has five branches in the State turning their person-to-person into banking institutions and it is amazing to me that State legislatures who have traditionally opposed interstate banking are more and more turning in this direction. Are you satisfied to let the States continue to make those decisions or do you think this is an area that Congress should act in as well?

Mr. **Clarke**. I am inclined to agree with you that things are moving very rapidly now. It is surprising to me that minds are being changed as fast as they are. I suppose a pretty good argument can be made that if nature is left to take its course interstate banking will become a reality in some manner just by the action of the States.

It occurs to me—and this is just a personal observation—that another way of getting there might be to say that as a matter of Federal policy, we no longer see a reason for having a prohibition on interstate banking. Accordingly, we would take down that barrier but allow States a fixed period of time to enact legislation that would create whatever type of barrier or whatever kind of banking climate they would like to see within their borders. I'm not sure that it's necessary to do that. That's just simply an idea of a way that it might be done.

The **Chairman**. Well, it's not necessary. The reason I smile is it's going to continue to happen. If the good old conservative Utah Legislature will do something like that, it's going to happen all over the country.

Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman.

EFFECTS OF DROP IN OIL PRICES

If we assume that oil prices stay down in the $10 to $15 a barrel range and stay there for a length of time, what appears to be the effect of that on our money center banks which have lent so heavily to Mexico particularly, but to other oil-producing countries? Do we have a problem there of consequence and, if so, could you describe it for us?

Mr. CLARKE. Senator, it's awfully difficult at this point to know the extent of the problem because so much of the effect of declining oil prices on the money center banks that have exposure to the oil-producing countries depends on what those countries can come forth with in terms of proposed restructurings or refinancings. You could make some fairly arbitrary calculations about the loss in revenue that would result at various price levels. I can tell you that it's certainly not good in terms of the effect that declining prices have on the oil-producing countries. The interesting thing about it, though, as I'm sure you know, is that falling prices will have very salutary effects on a number of other countries to which those banks also have exposure, as well as to many segments of our own economy. So it's a real mixed bag in terms of effects on the banking system.

Senator RIEGLE. Well, I guess I conclude from that that at this time you don't see the break in oil prices in terms of how that relates to outstanding loans to countries like Mexico as posing any really severe strains or problems for the commercial banking system in this country.

Mr. CLARKE. I don't think I would say that. I think it does pose a problem. I'm simply saying I think it's difficult to quantify the problem at this time. There's a difference between a borrower saying to an institution that he can't pay back his loan at all and saying to an institution that he can pay it back but it's going to take a longer period of time or perhaps have to be done at a lower interest rate. The effects are quite different, as I know you know.

Senator RIEGLE. Well, the sense I have is that the amount of additional lending that Mexico appears to need seems to be recalculated each week. It doesn't look like there's much more squeezing that can be done down there and I find my own sense of concern about it rising. So I guess we'll have to see more here to decide what to make of it. Let me take that problem and add two or three others to it, particularly as we think about the problems in the Southwestern part of the United States right now, particularly in your home State of Texas and Oklahoma, Louisiana, and Arkansas where we're finding a pileup of problems with agricultural loans and real estate loans particularly in Texas are a problem now, and in addition to that, the oil and gas lending which is also a severe problem right now.

When you take a look at this pileup of problems coming as they have sort of in a batch for that part of the country particularly, what can you tell us about the safety and soundness at the moment of the banking system in the larger banks particularly in that tier of the country and in those States starting with Texas, Oklahoma, Louisiana, and Arkansas?

Mr. CLARKE. Senator, I don't have right at the tip of my tongue any statistics that I can give you. I can say generally that there are some strains on the financial institutions in that part of the country and that it's something we are watching very closely.

Senator RIEGLE. How severe are they, would you say?

Mr. CLARKE. In some cases, I think quite severe although management, fortunately, has been handling those banks quite well.

POSSIBLE BANK FAILURES

Senator RIEGLE. I noticed in one of the morning papers—I don't have it right in front of me—there was a breakout of performances of Texas banks particularly and they seem to be hit awfully hard at the moment. I'm wondering if the scope and scale of this collection of problems hitting simultaneously is such that we don't get a turnaround here with that mix of problems somehow improving if we're going to find that there is going to be the likelihood of some major bank failures in that part of the country.

Mr. CLARKE. We certainly hope not.

Senator RIEGLE. Well, I hope not, too.

Mr. CLARKE. As I say, I think the management of those banks seems to be handling their problems quite well. Fortunately, the banks have been well capitalized in the past. They were very high-performing banks in the early 1980's, and I think that they are doing a very good job in identifying and dealing with the problems they have. It's not easy.

Senator RIEGLE. Well, I understand, but the tone I get from what you're saying is that these problems can be handled by good management and I'm wondering if that's really the case or if the scale and the number of problems occurring simultaneously may be sort of beyond the reach of just good management.

Mr. CLARKE. I don't think we're at that point. I think it's still a manageable problem.

Senator RIEGLE. What percentage of the banks in that part of the country today would be on your problem list?

Mr. CLARKE. Again, I can't quote you the specific number.

Senator RIEGLE. Can you get me just——

Mr. CLARKE. There are a large number of banks in that part of the country and in the Midwest that are on that list.

Senator RIEGLE. Would it be as much as 25 percent?

Mr. CLARKE. Yes.

Senator RIEGLE. Would it be as much as 50 percent?

Mr. CLARKE. I don't think so.

Senator RIEGLE. So it's somewhere between 25 and 50 percent? Closer to 25 or 50?

Mr. CLARKE. My guess is that it's closer to 25.

Senator RIEGLE. So assuming some figure about 25, I find that a figure of some concern.

Now you're localizing this, I take it, to the Southwest that I've identified and the Midwest, the areas where the problems are the greatest, is that right?

Mr. CLARKE. Remember, you have to keep in perspective what being on the problem list means. That doesn't mean that all of those banks will fail.

Senator RIEGLE. No, I would certainly hope not. If we lose 25 percent plus of the banks in those areas, we're in big trouble.

Mr. CLARKE. Those are simply banks that have been identified as needing closer supervision than others.

Senator RIEGLE. You know, no one saw Continential Illinois coming. That came as a big shock and surprise to many people and we're trying to work through it. It's costing us a lot of money to do so. It's proven to be more difficult than some thought at the time.

Do we have any potential here to see another large bank of that type run into the same scale of difficulty here insofar as we can tell? Do we have any other banks that are in serious difficulty and not to the state that Continental got to but in a zone that would cause us great concern?

Mr. CLARKE. I don't believe we have any at that stage.

Senator RIEGLE. We're clear that the stage I'm talking to is not the stage Continental got to where we had to intervene, but I mean in a dangerous path.

Mr. CLARKE. I don't believe we have any that are on that path.

Senator RIEGLE. We don't have any big money center banks whose situation is a troubling one where the situation is deteriorating? It's either stable or getting better?

Mr. CLARKE. I think that that would be a fair comment, that they are stabilized at this point.

Senator RIEGLE. So we don't know of any that would be in a situation where their position is worsening of the large money center banks?

Mr. CLARKE. Of course, I don't know what you mean by large, but I don't think——

Senator RIEGLE. The top 20.

Mr. CLARKE. In that category, I don't think there are any that we feel are not in stable condition.

Senator RIEGLE. Well, I don't want to quibble over words, but you can be stable and still have your situation deteriorating. Unstable implies sort of a real disequilibrium, but I take it you're saying we don't have any of the large top 20 banks who's been in some difficulty whose problems seem to be worsening at this point.

Mr. CLARKE. That's correct.

Senator RIEGLE. Thank you, Mr. Clarke.

The CHAIRMAN. Thank you, Senator Riegle.

Mr. Clarke, you say in your statement, "that a multitude of prohibited business activities are less risky than commercial or consumer lending." Could you be more specific of what activities you're talking about that are less risky than a normal commercial or consumer lending activity?

COMMERCIAL PAPER ACTIVITY

Mr. CLARKE. I think a good example is the one we were talking about earlier—commercial paper activity. When a bank takes on a loan on a long-term basis, whether long term is 90 days or 2 or 3 years, it still bears the risk that the condition of that borrower is going to deteriorate over time. That's a risk that can't be avoided with that type of lending. If a bank engages in something that passes through its hands for a brief moment where it's not retaining any of the risk, it seems to me that's inherently less risky.

The CHAIRMAN. Well, it's interesting that we have had a lot of testimony, particularly concerning the thrifts, not as much the banks, that they certainly shouldn't be granted any additional powers because they are too risky and yet the evidence is overwhelming that those banks on the troubled institutions list and particularly thrifts that are in trouble are in trouble because of good old-fashioned poor lending practices in traditional areas of lending that depository institutions have always been involved in.

That's why I wanted to pick up on that statement because the evidence has been overwhelming that the most serious threat to the institutions is normal bank lending and not any exotic new services or intruding into the realm of Glass-Steagall at all.

So I would agree with you that some of the new activities that are proposed are less risky than normal bank lending activities.

Further, you also state "to the extent that an activity exposes or is perceived to expose a bank to increased risk, there only remains the task of implementing safeguards to limit the exposure of the bank's capital."

Are you that safe in advocating a system that would include risk-related capital?

Mr. CLARKE. Let me be sure I understand the question.

The CHAIRMAN. Well, quoting your statement, you're talking about—"There only remains the task of implementing safeguards to limit the exposure of banks' capital," and what I'm asking you is to that task of limiting the exposure of the bank's capital, does that include any recommendations for risk-related capital?

Mr. CLARKE. Risk-related capital would certainly be involved in protecting a bank's capital and making sure it had enough of it. Also, restrictions on the ability of banks to engage in transactions with their affiliates need to be considered. If such transactions are believed to have potential for abuse, I think those can be walled off, so to speak, by appropriate regulation.

The CHAIRMAN. I also quote, "I think we'll find there are few, if any, activities that cannot safely be combined with banking."

Does that mean you're advocating a repeal of Glass- Steagall?

Mr. CLARKE. I realize taking that position is a fairly radical step, but it seems to me that a number of the objectives that Glass-Steagall sought to achieve at the time it was enacted are no longer relevant. I think that a new look should be taken at exactly what kinds of separations, if any, are really needed today and that if needed those separations could be achieved either by a newer model Glass-Steagall Act or by doing away with the Act altogether in favor of regulation. I'm not persuaded at this point that Glass-Steagall is necessary any longer in its present form.

The CHAIRMAN. Well, I would agree with you that there are parts of it that are certainly outdated and ought to be changed, as I have been trying to accomplish that for some time.

Mr. Clarke, thank you very much. We appreciate your testimony.

The committee is adjourned.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]

[Response to written questions of Senators Garn and Proxmire follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM

GEORGE D. GOULD

Garn Question 1

On page 11 of your statement, you stated the following:

> "Fourth, we need to reconcile states' authority to grant new thrift powers with FSLIC's financial responsibility to pay up if thrifts fail. We believe some proposals go too far in the direction of prohibiting state authorized activities."

Is your reference here to the "improper incident" proposal that is now included in H.R. 20, the so-called nonbank bank loophole closure bill?

Answer

Yes. Although some accommodation between the state-authorized activities of insured thrifts and FSLIC seems necessary, we believe the "improper incident" proposal you refer to ignores the states' interests entirely. It does not even link the "improper incident" determination to safety and soundness reasons. The FHLBB could overrule states just because the Bank Board considered state-authorized services to be "improper" for a thrift -- presumably because it strayed from its historical market.

We agree with Chairman St Germain and others who believe that states must recognize that the federal government is financially responsible for the risks undertaken by insured, state institutions. However, the dual banking system continues to serve our financial system well, and we want to preserve its benefits while protecting FSLIC. Accordingly, we have proposed a framework that balances these competing interests. The framework would permit state institutions to retain non-federal powers but only in holding company subsidiaries -- provided the Bank Board determines this extra protection of the FSLIC is necessary. Such a requirement would protect the federal government's interest without sacrificing the important benefits of the dual banking system.

Garn Question 2

It has been contended that the January 1, 1986 effective date of the provisions of Section 804 of the House-passed tax bill, the so-called troubled thrift provisions, is right now deterring acquisitions of troubled thrifts and thereby increasing the strains on the FSLIC fund.

Does the Treasury Department support a postponement of the effective date as it applies to these provisions?

Answer

Special rules enacted in 1981 permit the acquisition of a financially troubled thrift to qualify as a tax-free reorganization without regard to certain requirements generally applicable in other reorganizations. Qualifying as a tax-free reorganization allows the acquiring corporation to succeed to the tax attributes of the failing thrift. In addition to the special reorganization rules, an exclusion from income is provided for payments by FSLIC in connection with a reorganization.

Section 804 of H.R. 3838 would repeal these special rules effective January 1, 1986. Although the Administration agrees that repeal is appropriate because the special rules are a subsidy for FSLIC, the President's tax reform proposals recommended that repeal of these special rules be delayed until January 1, 1991. The delayed effective date was proposed because the thrift industry has not fully recovered from the economic difficulties which prompted Congress to enact the special rules in 1981. A five-year delay in repeal would permit FSLIC to seek to revise its premium assessment system to charge higher premiums or to charge risk-based premiums. In addition, most of the below-market mortgages currently in thrift portfolios should be repaid by 1991.

We continue to support the five-year delay in the effective date of these special tax rules as was proposed by the President.

Garn Question 3

You suggest that bank holding companies should be involved in securities, insurance and real estate activities. As a matter of equity, would you inversely recommend allowing the securities, insurance and real estate industries the authority to accept federally insured demand deposits?

Answer

I would like to answer Chairman Garn's third question and Senator Proxmire's fifth question together. For reasons I discussed in my written testimony, we believe Congress should authorize new financial products and services so that banking organizations can compete equitably with less regulated financial service firms and consumers of financial services can benefit from a more competitive environment.

Our position on specific activities is essentially unchanged from what the Administration has been urging since it proposed the Financial Institutions Deregulation Act in 1983. Bank holding companies initially should be able to compete in familiar and relatively low-risk securities businesses like underwriting and dealing in commercial paper, municipal revenue bonds, and mortgage-backed securities, and offering collective funds for IRAs and mutual funds. We think allowing BHCs to offer other securitized assets like auto loans and consumer accounts receivable also merits serious consideration.

We do not think full-service banking organizations should be authorized to affiliate with full-service securities firms or to underwrite corporate equity and debt securities or foreign securities at this time. We acknowledge that some people believe that the Glass-Steagall Act's separation of commercial banking from the securities business has served a useful purpose; we are not suggesting that it be eliminated immediately. What we are urging, as Secretary Baker testified before the Committee in June 1985, is that Congress enact certain selective exceptions to the Act where there is no evidence of undue potential risks. We then can evaluate the banking industry's experience with these new activities and their impact on the banking system and the financial services industry and later take additional steps if appropriate.

Banking organizations -- particularly smaller ones -- also should be able to offer insurance and real estate services to their local communities. At least initially, it may be judicious to restrict the role of banking organizations in these service areas to that of an agent or broker. More comprehensive powers could be phased in at a later date. As an alternative to dealing with these activities specifically, Congress could authorize activities "of a financial nature", as determined by the Federal Reserve, subject to whatever limitations Congress considers appropriate.

We also continue to support ownership by banking organizations of savings and loan associations. The thrift institution business should be approved as a 4(c)(8) activity for bank holding companies by the FRB with the sanction of Congress. Implementation of this approval first for troubled thrift institutions could assist FSLIC to dispose of institutions that can not survive independently and which need outside capital.

I do not believe that securities, insurance, and real estate firms should be able to accept federally insured deposits directly. However, firms that engage only in activities that are approved for depository institutions or their holding companies to engage in should be able to establish or acquire a subsidiary depository institution through which they can offer a full range of banking services, including federally insured demand deposits. Consequently, if the securities, insurance, and real estate activities of banking organizations are expanded, as we have proposed, then other firms engaged exclusively in those permissible activities should be authorized to acquire subsidiary banks.

In addition, under current law, firms engaged in any activity could acquire or establish a holding company with thrift institutions or nonbank banks as subsidiaries, and through them offer federally insured demand deposits. This ownership would be subject to the extensive limits on affiliate transactions in the bank and thrift holding company acts (*e.g.*, Section 23A of the Federal Reserve Act and Section 408(d) of the National Housing Act). Furthermore, the limits on the depository's lending activities (consumer loans for consumer banks, or the QTL test for thrifts) would further limit the range of depository activities of this new owner of depositories. This is an evolutionary way of determining what further affiliate regulation, if any, is necessary. I should stress, however, that the depository should be regulated and examined at least as closely as any other bank or thrift.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM

GEORGE D. GOULD

Proxmire Question 1

The Economic Report of the President's Council of Economic Advisers for 1986 has the following statement about the thrift industry:

"It may be appropriate to reconsider the wisdom of designating limited-purpose lenders, including mortgage lenders. The commercial banks have been very active in mortgage lending and their activity plus the success of firms in the secondary market for mortgages makes clear that mortgage lending does not require a separate subsidized financial sector."

This seems to me to be saying that we no longer need a savings and loan industry. If that is true, it has enormous implications about what we do to solve the FSLIC problem. What is the official position of the Reagan administration on this issue? Is the Council of Economic Advisers correct in saying we no longer need a thrift industry or do we still need a thrift industry, and if so, why?

Answer

The Treasury recognizes the significance of the thrift industry to the housing market and to many small communities and savers. That is one important reason why I have been spending a great deal of my time working on a program to strengthen FSLIC and the industry.

The nation's thrift industry (savings and loan associations and mutual savings banks) has long been and continues to be the single most important institutional participant in the mortgage market. For example, as of the third quarter 1985 total mortgage debt outstanding amounted to $2,183.9 billion, of which 34 percent was held by the thrift industry, 25 percent by federal (and related) agencies, 19 percent by commercial banks, 14 percent by individuals and other parties, and 8 percent by commercial banks.

The role of the thrift industry as the nation's foremost source of mortgage credit will not easily be supplanted. Furthermore, the extraordinary importance of the thrift industry to the effective and efficient functioning of the mortgage market makes it mandatory that any evolution of the industry take place with caution and over an extended period of time.

The events of recent years have made it clear that the thrift industry must adjust its business practices if it is going to operate in a sound fashion. These changed practices involve, of course, the business most thrift executives know best:

housing finance. Some additional ability to diversify income sources has also helped the thrifts. Most thrift managers have handled the transition well, despite the difficult times.

The Administration consistently has supported those steps that would provide the thrift industry with greater flexibility in the management of its assets and liabilities so that the industry could remain profitable throughout the interest rate cycle.

Thus, the Administration strongly supported the ability of thrifts to offer some additional services (as embodied in the Garn-St Germain Act) as well as deposit deregulation (through the efforts of the Depository Institutions Deregulation Committee). It encouraged the development of adjustable rate mortgages (with appropriate consumer protection features) to enable thrifts to shorten the duration of their assets. We also sought to promote the development of a private secondary market in mortgage securities, so thrifts would have more opportunity to function as mortgage bankers. Additional flexibility in services and liability structure of the thrift industry still is needed to ensure the viability of the industry in the years to come.

I believe that all of our depository institutions eventually should be able to specialize in those service areas in which they view themselves as having a competitive advantage, rather than as dictated by regulation. I also believe that changes in the financial markets will encourage this development. In my opinion, the Annual Report of the Council of Economic Advisers was merely reflecting this same viewpoint.

More likely than not, even in a completely open competitive environment most depository institutions would remain relatively specialized in those activities that now form the core of their businesses. And, as I see it, the only qualification we would want to place on the tendency to specialize is that similar regulation apply to institutions with similar specializations. Therefore, as recommended in the Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services, an institution which elected to be regulated as a thrift would have to meet certain portfolio requirements to qualify for that unique regulatory treatment; otherwise, the institution would be regulated as a bank.

Proxmire Question 2

You indicate in your statement that one way of beefing up the reserves of FSLIC is to permit it to borrow from the Federal Home Loan Banks. However, some Wall Street analysts say that any increased borrowing by the Home Loan Banks for the purpose of loaning money to FSLIC will weaken the credit rating of the Home Loan Banks. As a result, the Home Loan Bank system will have to pay more for its money and charge more for its advances to the savings and loan industry. In the end, the savings and loan industry will pay for the increased funds just as they would be required to pay through a FSLIC premium increase.

If this analysis is correct, aren't we just kidding ourselves by fooling around with Home Loan Bank borrowing. Wouldn't we be better off by raising premiums directly?

Answer

No. I am pleased that you asked this question, because it is important for the Congress to recognize the significant role the FHLBanks can play to help FSLIC and the industry.

In proposing that the Federal Home Loan Banks provide assistance to FSLIC, both the Administration and the Federal Home Loan Bank Board have been very cognizant of the potential adverse effect on the FHLBanks' credit rating and cost of funds. As I stated in my testimony, any financing "package" must be attentive to the FHLBanks' position in the debt markets. I have met with both the Chairmen and the Presidents of the FHLBanks to discuss this concern.

Consequently, in structuring a specific proposal, the FHLBB and the Treasury are examining the merits of a unique structure that would maintain the financial strength of the FHLBanks. One option involves the establishment of a separate funding facility, capitalized by the FHLBanks, which would issue its own debt. Since the funding would be discrete rather than blended with normal operations, the potential impact on the borrowing cost of the FHLBanks' regular consolidated obligations would be lessened.

In addition, borrowing through the funding facility, a relatively small amount of the FHLBanks' overall borrowing, could be uniquely collateralized. These factors would minimize the adverse impact.

If FSLIC relies only on premium income, it is unlikely to draw sufficient funds to handle problem cases in a timely manner. The FSLIC has already bolstered the fund and increased its capacity to resolve problem cases by invoking the authority to impose special premium assessments. (The statutory limit on the special assessment is an additional 1/8 of one percent of deposits annually; the regular assessment is 1/12 of one percent of deposits annually.) Even with this additional premium income, the size of the problem exceeds the available resources.

Congress could grant FSLIC statutory authority to increase the size of the special assessment. However, two problems might arise from this action. First, additional premiums would represent an immediate expense for thrifts, and troubled institutions would have great difficulty meeting this expense. The extra payments would push more thrifts into insolvency. Second, significantly higher premiums might provide an impetus for some thrifts, especially the strongest thrifts, to switch to FDIC insurance. Obviously, the industry would oppose higher assessments vigorously.

Without recapitalization of the fund, the FSLIC would need to continue deferring the resolution of some problem cases. In all probability, deferral will only increase the fund's ultimate costs. Also, given the very favorable interest rate environment, now is an ideal time to move quickly to resolve current problems.

The FHLBanks are a very strong and well-capitalized segment of the thrift industry whose resources have yet to be significantly tapped in seeking an industry solution. Their $1.8 billion of earned surplus (year-end 1985) could be employed promptly to draw additional funds to solve problem cases. If FSLIC can rely on the FHLBanks, it can in effect draw funds against its future stream of assessment and investment income. FSLIC could then resolve more problem cases while avoiding encumbering the industry with a full recapitalization effort immediately.

Proxmire Question 3

Some students of our financial system including Prof. Kane of Ohio State believe we made a big mistake in 1980 when we raised the deposit insurance limit to $100,000. Kane argues that this limit should be gradually reduced to $10,000 over the next several years.

What is the view of the Administration? Is the $100,000 limit about right, or should it be reduced?

Answer

I suspect that it would be quite difficult to determine some "optimum" deposit insurance limit that efficaciously transcends both time and economic events. To the extent we wish to view deposit insurance solely as a protection for small depositors, the weight of the arguments probably favors a deposit insurance limit considerably less than the current $100,000. On the other hand, to the extent we rely at least to some degree on the deposit insurance system to underwrite overall financial system safety and soundness by reducing the volatility of flows of funds, the current insurance limit may be reasonable.

It seems to me that Congress already has elected to view federal deposit insurance as having the dual purpose of protecting small depositors as well as advancing system stability. As my statement for the Committee noted, famous economists of divergent views agree on the importance of deposit insurance for systemic stability. The concern for systemic protection was especially evident in the financial reform legislation of 1980, which established the current $100,000 deposit insurance limit. To the best of my understanding, the 1980 change was much less a matter of protecting small depositors than it was a response to the fears of numerous depository institutions, most notably the savings banks of the Northeast. The major concern at that time was that holders of uninsured deposits (in excess of $40,000) were poised to withdraw their funds quickly at the slightest hint of an institution in difficulty. Congress was sufficiently concerned about this type of threat to system stability to increase the deposit insurance limit to its current level.

I am not inclined to view a change in the insurance limit yet again as a high priority. Those institutions currently burdened with sectoral loan problems (such as real estate, third world debt, agriculture, and energy) could possibly be victimized by severe liquidity problems if steps were taken now to reduce the insurance limit. Rather, I would suggest that Congress should consider the numerous other reforms that Chairman Seidman and I proposed to improve the overall funding capacity and operating capabilities of the federal deposit insurance funds.

Proxmire Question 4

Mr. Gould, I didn't notice much in your statement about risk-based insurance premiums. Was that a deliberate oversight? Does it mean the Administration does not believe risk-based insurance is a useful tool in strengthening our deposit insurance system?

Answer

My testimony focused on three primary issues: 1) the long-term prospects of depository institutions, 2) the critical problems facing the thrift industry and the need for providing the FSLIC with additional funds, and 3) some operational deposit insurance issues. Within this context, we did not reiterate at length several key recommendations that the Administration has previously made regarding the functioning of the deposit insurance system -- including risk-related premiums, increased capital, and modification of accounting and disclosure standards.

Nonetheless, the Administration continues to support experimental and evolutionary implementation of risk-related premiums as a very useful tool for introducing greater management and stockholder discipline, which should reduce problems and inequities in the future. This concept was endorsed by the Vice President's Task Group on Regulation of Financial Services, a Working Group of the Cabinet Council on Economic Affairs, and Secretary Baker in his testimony before the Committee last June.

Proxmire Question 5

I would like to go down a list of activities and ask you whether the Administration supports or opposes these services being performed by bank holding companies.

1. operating an insurance agency or brokerage;
2. underwriting property and casualty insurance;
3. underwriting life and health insurance;
4. operating a real estate brokerage;
5. engaging in real estate development and management;
6. operating a full service securities firm;
7. underwriting municipal revenue bonds;
8. underwriting mortgage backed securities;
9. offering mutual funds;
10. underwriting corporate or foreign securities;
11. operating a savings and loan association.

Answer

Please see our response to Chairman Garn's third question.

Proxmire Question 6

As you know, large banks do not pay any FDIC insurance premiums against their foreign deposits even though these deposits are in effect 100 percent insured. Since the big banks get almost half their money through foreign deposits, this gives them a real competitive advantage over smaller banks.

As a simple matter of competitive equity as well as sound management, why shouldn't the big banks be required to pay insurance premiums on their foreign deposits?

Answer

Frankly, I am concerned that your proposal increases the costs for large international class banks and does not increase the size of the insurance fund. The offsetting benefit for most other U.S. banks is minimal. I think Congress and the Administration must consider (1) whether the benefits of this plan outweigh the competitive problems it will create in the international lending market, and (2) to what extent the plan will strengthen the safety and soundness of the deposit insurance system.

I recognize the arguments in favor of assessments on foreign deposits. Every large failing money center bank has been handled through a merger that has protected all depositors (domestic and foreign) against loss. Most uninsured domestic depositors also never suffer a loss, because few banks fail and only a few that do are liquidated. But: (1) the assessment on domestic deposits is based on both insured and uninsured accounts; and (2) some smaller institutions are liquidated.

Advocates of the assessment contend that the U.S. should not subsidize international banks through the deposit insurance system just because these banks face competitive pressures.

On the other hand, there seems to be considerable merit to the arguments of international bankers that an assessment on foreign deposits would: (1) put American banks at a cost disadvantage with respect to foreign institutions; (2) lead U.S. banks to reduce excess deposits, cutting into their liquidity and that of the market; (3) reduce earnings and internally generated capital; and (4) discourage many regional banks from entering the Eurodollar and foreign lending markets.

Furthermore, the yields required by foreign depositors suggest that they do not consider themselves insured. And if the Congress decided to extend insurance to foreign deposits of $100,000 or less, we might create difficult foreign policy issues linked to foreign treatment of U.S. banks and their depositors.

I have participated in several discussions within the Administration on this subject. We are giving it very careful consideration but we have not yet reached a decision. One option may be to increase the payments of international banks in some fashion without relating the extra sum directly to their foreign deposits.

Proxmire Question 7

Some students of the financial system suggest that we would have a safer system if banks and thrift institutions were required to adopt market value accounting -- that is assets and liabilities would be marked-to-market to reflect changing interest rates. This type of accounting would act as a powerful incentive to achieve a better maturity match between assets and liabilities.

What about this concept? Is it something we should be moving towards over the next several years?

Answer

While I believe market value accounting is an important discipline for organizations that have short term assets and liabilities, like securities brokers-dealers, I am not sure that it is equally appropriate for organizations with longer maturing assets and liabilities -- like banks and thrift institutions.

Market value measures of net worth reflect the effects of changes in interest rates on the book value of assets and liabilities. Net worth on a mark-to-market basis attempts to ascertain the value for which specific assets and liabilities could be sold at a specific point in time. Thus, it is a rough measure of an institution's value in liquidation.

This measure of net worth is a very advantageous tool in providing a current value measure of net worth. However, market value measures also have several significant limitations.

First, mark-to-market analysis adjusts asset and liability values only to take into account changes in interest rates; it does not reflect credit quality. Furthermore, as the market for adjustable rate mortgages made clear, investors can, to a degree, trade off interest rate risk for credit risk. But mark-to-market analysis only captures one of these risks. Given the increasing role played by asset quality problems in troubled thrifts, the failure to account for credit quality introduces significant errors into the analysis.

Second, if an institution is going to be liquidated, market values are essential in determining the FSLIC's costs. But most cases of failed thrifts are not resolved through liquidation. Instead, FSLIC relies on assisted mergers or acquisitions in the vast majority of cases. In these instances, factors such as customer loyalty and location provide troubled or failed institutions with an ongoing franchise value. Consequently, most thrifts are worth more than the market value difference between assets and liabilities.

Third, this market value method provides a static rather than a dynamic economic analysis. It approximates the market value of an institution's assets and liabilities, but only at a given point in time. Assessments of an institution's future value, which is what buyers of stock are most interested in, depend on a dynamic analysis that includes assumptions as to future profitability. Businesses are often worth more than the market sum of their parts. The fact that dozens of thrifts with significantly negative mark-to-market net worth have successfully sold stock and gone public underscores the importance of a dynamic analysis of future value as a supplement to a static measure of current market value. The market value of a company's stock will rarely equal its marked-to-market balance sheet at a given point in time.

Finally, in a volatile interest rate environment, market value net worth can swing widely over a brief time period. These swings are not really indicative of changes in the institution's ongoing value -- unless one assumes that the rates will suddenly stay constant for a long time period. As an illustration, market value net worth as a percentage of assets for all FSLIC-insured institutions was -17.32 percent at the end of 1981 and -2.74 percent at the end of 1984. By year-end 1985, the market value of the thrift industry's mortgage portfolio exceeded book value.

In sum, the mark-to-market method, like other modes of financial analysis, can be useful if its limitations are understood. These limitations are both technical and interpretative. In combination with other information, and good judgment, a mark-to-market analysis can be beneficial. I would add, however, that other types of analysis (e.g., calculation of duration gaps and simulations) can also clarify the risks and benefits of a mismatched portfolio.

Proxmire Question 8

Despite the deregulation that has already taken place, banks are still prohibited by law from paying interest on demand deposits. I notice there was nothing in your statement on this issue. Do you favor deregulation in this area, and if so, why have you been so reticent in espousing its benefits?

Answer

The Administration has been a strong advocate of removing the prohibitions against paying interest on demand deposits. In 1983 the Depository Institutions Deregulation Committee submitted legislation, the "Demand Deposit Deregulation Act," to accomplish this purpose. The House Banking Committee held hearings on the issue, and Treasury testified in favor of the legislation. However, no action was taken at that time, and neither the Senate nor the House has given the issue serious consideration since.

Admittedly, the payment of interest on demand deposits, as an independent issue, has not been one of our highest legislative priorities. When Treasury testified on this issue in 1983, we noted the potential adverse earnings impact of this proposal on some institutions and concluded: "While the Administration can support the payment of interest on demand deposits as a matter of principle, it seems quite clear to us that demand deposit deregulation should be viewed within the context of a commitment to more comprehensive product deregulation."

Consequently, we have focused primarily on the depositories' needs to remain competitive -- to earn profits to offset higher liability costs, to supply more services to customers, to protect the safety and soundness of the system. Nonetheless, we continue to favor the payment of interest on demand deposits and would support its inclusion in a comprehensive legislative package that enabled depositories to earn money to offset the higher cost.

Proxmire Question 9

As you know, legislation has been introduced to authorize a new kind of bank called a Consumer Bank. Consumer banks would have more limited powers compared to commercial banks and would not be subject to certain restrictions on branching and ownership.

Does the Administration support the enactment of legislation authorizing consumer banks?

(follow-up) Isn't the concept of a consumer bank a major step backwards from the trend of financial institution legislation over the last 20 years during which time we have gradually eliminated artificial distinctions among different types of financial institutions. With the consumer bank concept, we would be moving away from generalized powers and back towards specialized powers?

Answer

I don't view the Administration's position in favor of consumer banks as a major step backwards from the trend of financial legislation of recent years. To the contrary, the consumer bank provides us with an evolutionary step forward to that day when we no longer artificially segment classes of institutions according to the particular activities of those institutions. Rather, what we must do in the future is to see to it that any organization involved in a wide range of financial and/or nonfinancial activities is prohibited only from exploiting those activities in a manner which is abusive of the public good. Let me explain what I mean by this.

Traditionally our regulatory structure has focused on artificially segmenting institutions according to the basic types of activities engaged in. Thus, firms engaged in certain financial activities have been "fenced off" from firms engaged in commercial activities. Also, firms engaged in some types of financial activities have been "fenced off" from firms engaged in other types of financial activities (e.g., investment banking vs. commercial banking). This framework of wholly specialized institutions was intended to prevent potentially abusive market practices involving credit allocation, tie-ins, and the like. It also probably found support among business leaders who didn't want others competing in "their" respective markets.

Our recent experience with the traditional segmentation of entire classes of institutions has not been an altogether happy one. Depository institutions, and thrifts in particular, have had great difficulty in maintaining profitability throughout the economic cycle because of excessive dependency on a limited range of service activities (or concentration of lending in certain regional businesses). The inability of these institutions to diversify sufficiently is now being paid for in the weakened condition of the federal deposit insurance funds and a scarcity of capital for significant numbers of institutions.

The only permanent remedy for the current situation is a movement away from de jure specialized institutions. We must move forward to that environment in which practically any business organization can participate in all aspects of the markets for goods and services, financial and nonfinancial alike. In that new environment the focus of our regulatory attention must be on the activities themselves and on the provision of whatever rules and regulations are necessary to assure that market abuses are not engaged in. Indeed, we already have encouraging experience with regulations of this very type.

In my opinion, therefore, the consumer bank offers us an excellent opportunity to take a modest step in the direction of the future. This bank would be fully regulated as is any other federally chartered depository institution. It would be subject to the significant restrictions on affiliate transactions in the Federal Reserve Act (e.g., section 23A). The traditional concern about linking sources of commercial lending to commercial borrowers through common ownership should be alleviated by the fact that the consumer bank would not make commercial loans.

The consumer bank would concentrate on the market for consumer services, enhancing the competitive benefits of greater convenience, lower prices and more imaginative service offerings. Its less onerous restrictions on ownership would attract more capital and managerial talent to banking markets. It would provide us with the experience to assess the implications of a more complete restructuring of our banking markets according to activities rather than classes of institutions. Finally, it is a measure that is in concert with current market forces, not one that attempts to "turn the clock back" to where it cannot go; it enables us to develop the appropriate regulation "from the start," instead of missing the opportunity because we are intent on prohibiting changes that will not be stopped.

Some commentators have sought to oppose the consumer (or nonbank bank) by asserting it is unregulated. Such statements are untrue. To underscore their degree of regulation, I have attached a paper that lists the major laws to which they are subject.

March 28, 1986

THE REGULATION OF NONBANK BANKS

Opponents of nonbank banks frequently attempt to create the impression that nonbank banks are unregulated financial institutions. They argue that legislation is needed so that such limited purpose institutions will not be permitted to engage in such practices as providing loans and other financing to affiliates, lending to suppliers of affiliates, discriminating in extending credit, and engaging in unlawful tying practices. It is further argued that such institutions present risks to the payments system not presented by "regulated" institutions.

The truth, of course, is quite to the contrary -- as many opponents know, or should know. Nonbank banks are fully regulated financial institutions, subject to all of the laws and regulations to which full-service banks are subject.

The following summary sets forth the principal regulatory and supervisory constraints applicable to both nonbank banks and full-service banks.

Examinations. Nonbank banks are regularly examined by the same state and federal banking authorities that examine full-service banks.

Affiliate Lending. Nonbank banks, just as full-service banks, are subject to section 23A of the Federal Reserve Act. This law restricts lending to any one affiliate to 10 percent of the bank's net worth, and limits lending to all affiliates in the aggregate to 20 percent of net worth. Purchases of assets from affiliates, investments in the securities of affiliates and guarantees issued on behalf of affiliates are also subject to these limits.

Even within these volume limits, loans to affiliates must be at least 100 percent collateralized, and all transactions with affiliates are required to be "consistent with safe and sound banking practices." Section 23A further restricts the purchase by a bank from an affiliate of a "low-quality" asset.

A loan made to a third party where the proceeds are used for the benefit of an affiliate or are transferred to an affiliate, is deemed to be a loan to the affiliate itself and is subject to section 23A limits.

There is, therefore, no greater risk that nonbank banks will be used to advance the interests of affiliates than in the case of full-service banks.

Insider Lending. Nonbank banks are subject to all of the same limits as full-service banks imposed by section 22 of the Federal Reserve Act and the Fed's Regulation O on loans to executive officers, principal shareholders and entities controlled by such persons. The aggregate of all loans to any such person and his related entities cannot exceed the bank's limit on loans to a single borrower. Loans to such persons and entities, as well as loans to directors, cannot exceed $25,000 absent special approval by the bank's board, and all such loans are required to be nondiscriminatory, in terms of interest rates, collateral and payment risk, as compared to loans to persons unrelated to the bank.

Margin Regulations. Nonbank banks are subject to the same margin rules (Regulation U) -- that is, rules relating to lending for the purchase of securities -- as are full-service banks.

Reserve Requirements and Deposit Interest Rate Controls. Nonbank banks are subject to the same reserve requirements (Regulation D) and deposit interest rate limits (Regulation Q), as full-service banks.

Capital Adequacy. Nonbank banks are subject to the same capital requirements and guidelines as full-service banks, and are fully subject to the authority of the federal bank regulators under the International Lending Supervision Act of 1983 to set and enforce levels of capital adequacy for individual banks.

Dividend Limits. Nonbank banks may only pay dividends to their shareholders under the same circumstances as full-service banks may pay dividends.

Lending Limits. Nonbank banks are subject to the same limitations on loans to a single borrower as full-service banks.

Payments System. Nonbank banks are fully subject to the Federal Reserve's Regulation J, which governs check collection and wire transfer procedures.

Discount Window Advances. Nonbank banks are not permitted access to the Federal Reserve discount window except on the same terms and conditions as full-service banks.

"Nonbank" Activities. Nonbank banks may not engage directly or through subsidiaries in any activities that would be prohibited to their full-service counterparts under state or federal law.

Changes in Control. The acquisition of nonbank banks is subject to extensive regulation. No person or company may acquire a nonbank bank without full scrutiny by a federal bank regulator. Under the Change in Bank Control Act, the federal authority may deny permission to acquire such a limited purpose bank if it finds (a) that the financial condition of the acquiring entity might jeopardize the financial stability of the bank or prejudice the interests of depositors; (b) that the competence, experience or integrity of the acquiring entity is such that it would not be in the interests of depositors or the public to permit the acquisition; or (c) that relevant antitrust standards would be violated. These are the same standards applicable under the Change in Bank Control Act to acquisitions of full-service banks.

Chartering and FDIC Insurance. Any person or company that proposes to charter a nonbank bank, or to obtain federal deposit insurance for such a bank, must satisfy all of the financial, managerial and other standards as are applicable to full-service banks. Once FDIC insurance is granted, nonbank banks pay the same premiums, and are subject to the same assessments, as full-service banks.

Bank Merger Act. Any merger involving a nonbank bank is subject to scrutiny on antitrust grounds, both by a federal banking agency and by the Department of Justice.

Branching. Nonbank banks are subject to the same state and federal limitations on branching as are full-service banks.

Management Interlocks. Officers, directors and employees of nonbank banks are subject to the same limits on interlocking service with other depository institutions as their counterparts in full-service banks.

Unlawful Tying Practices. Nonbank banks are subject to those federal antitrust laws, including section 3 of the Clayton Act and Section 1 of the

Sherman Act, that prohibit anticompetitive tying arrangements and that provide treble-damage and injunctive remedies for violations. While nonbank banks are not also subject to anti-tying provisions of the Bank Holding Company Act, Congress could certainly make them applicable if it considered that extra protection appropriate.

Glass-Steagall Act. Nonbank banks are subject to the same limits on securities activities, and interlocks and affiliations with securities firms, as full-service banks.

Consumer Protection Laws. Nonbank banks are fully subject to all of the following consumer protection measures to the same extent as full-service banks:

Truth-in-Lending
Truth-in Leasing
Equal Credit Opportunity Act
Home Mortgage Disclosure Act
Community Reinvestment Act
Fair Credit Billing Act
Federal Trade Commission Improvement Act (unfair and deceptive practices)
Fair Housing Act
Fair Debt Collection Practices Act

Fair Credit Reporting Act
Electronic Funds Transfer Act
State and federal usury laws
Real Estate Settlement Procedures Act

Enforcement Sanctions. Nonbank banks are as susceptible as full-service banks to the powers of banking regulators to issue cease-and-desist and removal orders and to impose civil money penalties for violations of laws and regulations.

Bank Protection. Nonbank banks are fully subject to the provisions of the Bank Protection Act of 1968, which sets out minimum standards for bank security systems.

Right to Privacy. Nonbank banks are fully subject to the Right to Financial Privacy Act of 1978.

Bank Secrecy Act. Nonbank banks are fully subject to the provisions of the Bank Secrecy Act, which establishes reporting and recordkeeping requirements relating to currency transactions.

Bank Bribery Act. Nonbank banks are fully subject to the provisions of the Bank Bribery Act prohibiting payments and gratuities to bank employees in connection with bank business.

The only difference between full-service banks and nonbank banks relates to certain restrictions on the owners of such institutions. Those provisions of the Bank Holding Company Act that limit the nonbanking activities of corporate owners of full-service banks, and that limit the ability of bank holding companies to own full-service banks in more than one state, are inapplicable to owners of nonbank banks. As is apparent, however, with these exceptions, nonbank banks are subject to all of the same federal laws and regulations as are full-service banks. There is no basis whatsoever for any suggestion that nonbank banks will be any more likely to violate such laws or regulations or that nonbank banks will be operated any less prudently, than their full-service counterparts.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM ROBERT L. CLARKE

1. Q. If we amend Garn-St Germain to permit acquisition of bank holding companies, would the FDIC be placed in the position of insuring holding companies?

A. No. Permitting the interstate purchase of bank holding companies would not change the present relationship between holding companies and the FDIC, which insures only the bank subsidiaries of holding companies. The FDIC would not insure either the holding company parent or any nonbank affiliate. The FDIC would continue to insure only bank deposits in accordance with federal law, and therefore, the amount of insured deposits would not be affected by the expanded authority to approve interstate bank acquisitions.

In fact, it is expected that such expanded authority would benefit the FDIC insurance fund. The number of potential bidders for failing banks would be likely to increase due to the opportunity for the acquirer to buy a group of banks, as opposed to a single bank. This would be particularly true in states where branching restrictions would otherwise limit the ability of an out-of-state acquiring bank to expand once the single bank is purchased. Thus, it is likely that some bank or bank holding company acquisitions could take place without FDIC assistance. And in those that required assistance, the premiums paid by acquiring banks in a purchase and assumption transaction arranged by the FDIC would be likely to rise, thereby reducing the net costs to the FDIC of winding up the affairs of a failed institution.

2. Q. You say:

"As of mid-year 1985, the U.S. banking offices of foreign institutions held a 22 percent share of the U.S. business lending market."

Should Congress increase the regulation of foreign institutions or "unleash" the American banks to allow them the ability to compete in today's marketplace?

A. Congress should, without question, increase competitive opportunities for U.S. banks and not consider imposing new restrictions on foreign banks.

Increased restriction of foreign banks would address only a small part of the problem faced by U.S. banks since foreign banks are not the only competitors of U.S. banks. In fact, in nearly every aspect of their business, U.S. banks find many competitors. In commercial lending, they face stiff competition from both financial and nonfinancial firms offering commercial paper, deferred payment plans (i.e., trade credit), commercial leases, and accounts receivable financing. In consumer lending markets, they compete with captive and independent finance companies, thrift institutions and large retail establishments. Finally, as suppliers of deposit services and consumer investment instruments, banks face competition from thrift institutions, stock brokerage firms, the federal government (with its offerings of savings bonds and Treasury securities) and those offering mortgage securities such as the Federal National Mortgage Association, Government National Mortgage Association and the Federal Home Loan Mortgage Corporation.

Intense competition from all those sources creates a compelling need for increased product and geographic opportunities for U.S. commercial banks.

3. Q. You say in your statement:

"that a multitude of prohibited business activities are less risky than commercial or consumer lending."

Will you be more specific? What activities are you referring to?

A. Examples of prohibited activities that are less risky for a bank than direct lending include underwriting commercial paper and long-term corporate debt. Commercial paper and corporate bonds are close substitutes for bank credit, but the underwriter of those instruments is exposed to risk only until they are sold to investors. When a bank makes a loan, however, it is subject to a multitude of risks, including changes in the economy, the fortunes of the borrower, and the cost of funding the loan. Similarly, underwriting state and local government revenue bonds involves risks that are similar to underwriting general obligation bonds, which is permitted.

Other activities such as real estate brokerage, full-service securities brokerage, and insurance brokerage involve executing purchase and sell orders for customers. Such activities expose a bank's liquidity and capital to little risk and are certainly less risky than making and holding loans.

4. Q. You state that:

"I think we will find that there are few, if any, activities that cannot safely be combined with banking."

Are you advocating a repeal of the Glass-Steagall Act and Section 4 of the Bank Holding Company Act?

A. Sections of the Glass Steagall Act and the Bank Holding Company Act should be amended to enable firms to offer both banking and other services. However, to insulate deposit-taking and closely related services from losses resulting from a firm's involvement in nonbanking activities, new controls may be needed. They could address, among other things, the capitalization of a firm's subsidiaries, loans among affiliates, and public disclosure.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
ROBERT L. CLARKE

1. Q. I didn't see much in your statement on brokered deposits. Does this mean you don't think brokered deposits are a serious problem?

(follow-up) Would you oppose any effort to limit the growth of brokered deposits?

A. Deposit brokering can perform a valuable economic function for both depositors and financial institutions. The use of brokered deposits can also be abused by banks. Despite the highly publicized concerns raised by brokered deposits, the OCC does not in general consider them a serious problem. We have adequate authority both to monitor banks' use of brokered deposits, and to apply restrictions and limitations on a case-by-case basis when deemed necessary. Moreover, while we recognize the need for more market discipline and for greater protection of the insurance funds, we see no apparent reason for absolute limitations on the growth of brokered deposits.

2. Q. A recent survey by the Los Angeles Examiner showed that California banks pay significantly less on consumer deposits compared to New York Banks.

Of course, California has had statewide branching for a long time and as a result, it has one of the highest concentration ratios in the country.

This suggests to me that if we have unrestricted interstate branching, we will have higher concentration ratios in banking and the end result is that consumers will pay more for their loans and get less on their deposits.

What is wrong with this analysis?

A. California has over 1,800 commercial banks and thrift institutions, including credit unions. In addition, consumers in California have access to money market mutual funds, out-of-state banks through national advertising, and other sources of savings instruments. This suggests two conclusions. First, California consumers have a wide variety of choices in where to place their savings. Second, even in a state with large statewide banks and bank holding companies, independent banks and other financial institutions are able to compete successfully.

With at least 1,800 competitors, it is hard to imagine that a lower interest rate on consumer deposits results from concentration of banking firms. Presumably any of those 1,800 could choose at any time to capture market share by increasing the rate paid on deposit accounts.

While unrestricted interstate branching may lead to fewer banking institutions in the United States, a decline in the number of banking institutions does not automatically imply an increase in concentration in local or even statewide banking markets. Nor does an increase in concentration, if in fact one should occur, necessarily imply that consumers will be harmed. Concentration is not necessarily the antithesis of competition.

The effect of unrestricted interstate branching on local and statewide banking markets is difficult to predict. Not all such markets would necessarily be attractive to out-of-state institutions. For markets that are attractive, de novo branching and the replacement of branches of local banks by out-of-state banks would reduce concentration ratios or leave them unaffected. Competition and the prospects of entry by local banks (for example, through new charters extended to local community groups) would help assure that out-of-state banks meet the deposit and credit needs of local communities.

Even if local markets were to become more concentrated, it does not necessarily follow that consumers would receive less for interest-bearing deposits and pay more for loans, and that this would result in banks becoming more profitable. The idea that consumers are better served by relatively unconcentrated banking markets has been investigated by numerous researchers. A reviewer of the literature recently observed that many studies did not show a statistically significant relationship between concentration and profits.[1/] Further, this reviewer cited another researcher who concluded that the literature "...contains so many inconsistencies as to provide no evidence of a positive association between concentration and performance in banking".[2/]

The absence of clear-cut evidence supporting a causal link between concentration ratios and bank performance is surely due to many factors. Perhaps the most significant is the fact that today, banks are not the only source of credit, short-term savings instruments and deposit services. Banks face competition in each of their product markets from a variety of financial and, in some cases, nonfinancial firms. It is the presence of that competition that argues so persuasively for expanded branching and product powers for banks.

1/ Michael Smirlock, "Evidence on the (Non)Relationship Between Concentration and Profitability in Banking," Journal of Money, Credit and Banking, November 1984, Part 2, pp. 617-645. Also see, Alton Gilbert, "Bank Market Structure and Competition," Journal of Money, Credit and Banking, November 1984, Part 2, pp. 617-645.

2/ Smirlock, p. 70. The reference is to Dale K. Osborne and Jeanne Wendel, "Concentration and Checking Account Prices: A Note," Journal of Finance, March 1981, pp. 181-186.

3. Q. The key assumption behind the case for expanded bank powers made by you and Mr. Gould is the notion that the commercial banking industry is hurting -- that is, bank profits are declining as well as their market share compared to other financial intermediaries.

What evidence is there to support this view of declining bank profits and market share?

(follow-up) Provide detailed figures for the record.

A. There are ample data in support of both phenomena. The decline in bank profitability can be seen by looking at return on assets (ROA). As shown in Table 1, since 1980, there has been a substantial decline in the percentage of high-earning national banks (those with ROA greater than one and one-half percent) and a substantial increase in national banks experiencing losses (those with negative ROAs). The data presented in Table 2, which show, for the same time period, trends in the lowest quartile ROA for national banks in various size categories, corroborate that bank performance has generally deteriorated. Small national banks (under $25 million) experienced the most dramatic decline in ROA. In 1980, 25 percent of this size group of banks had a ROA of 0.85 percent or lower; however, by 1985, they had a ROA of - 0.67 percent or lower. (See Table 2, last column.)

TABLE 1
Percentages of National Banks with High Earnings and Losses

	ROA over 1.5 (Percent of banks)	ROA under 0 (Percent of banks)
1980	21.6%	3.0%
1981	24.7	4.2
1982	21.8	6.5
1983	18.3	8.9
1984	14.3	12.2
1985	13.4	16.2

Source: Call Reports.

TABLE 2
Lowest Quartile ROA for National Banks, by Bank Size

	Banks with Assets					
	over $10B	$1B-$10B	$100M-$1B	$50M-$100M	$25M-$50M	Under $25M
1980	0.51	0.67	0.75	0.90	0.89	0.85
1981	0.41	0.63	0.68	0.77	0.82	0.80
1982	0.38	0.58	0.65	0.80	0.79	0.63
1983	0.26	0.56	0.64	0.73	0.69	0.38
1984	0.20	0.56	0.70	0.69	0.55	0.06
1985	0.41	0.59	0.69	0.60	0.41	-0.67

Source: Call Reports.

The declining market share of banks compared to other financial intermediaries is evident from Federal Reserve Board flow-of-funds data shown in Table 3. Both commercial banks' share of lending by financial firms, and their share of lending by all private-sector creditors, have fallen markedly since 1982. The decline in commercial banks' market share in the second series reflects the dramatic inroads made by non-financial firms.

TABLE 3

Commercial Bank Lending-Market Shares

	Commercial Bank Share of Lending by Financial Firms	Commercial Bank Share of Lending by all Private-Sector Creditors
1980	24.9%	21.9%
1981	25.2	21.3
1982	29.2	23.5
1983	28.9	21.9
1984	27.4	20.7
1985	23.9	16.1

Source: Flow-of-Funds Accounts, Fourth Quarter 1985, Board of Governors of the Federal Reserve System, pp. 50-51.

4. Q. Your predecessor said at a Congressional hearing that the eleven largest banks would not be permitted to fail.

Have you changed this policy since you became Comptroller, or are you following the same policy?

A. There is not now, nor has there ever been, a federal policy that dictates which banks can and cannot fail. Each failing bank is handled according to its individual circumstances, in a way that is deemed to be least costly to the FDIC and least disruptive to the banking system and the public. For the majority of banks, this means a purchase and assumption transaction. For others, it means a payout of insured deposits. In a few instances, more unusual solutions are employed, such as open bank assistance.

The failure of one of our largest banks would have far more serious systemic effects than the failure of a very small bank. That would, in my judgment, be reason for handling such a failure differently.

5. Q. The Federal Reserve has proposed new capital standards which among other things would require banks to maintain capital against off-balance sheet liabilities such as stand-by letters of credit.

Do you favor the concept of counting off-balance sheet items in determining capital requirements?

A. Many off-balance sheet activities, such as standby letters of credit, entail risk to the bank. Yet current capital requirements do not explicitly account for this risk. The OCC believes that consideration should be given to including those types of risks in the determination of capital adequacy.

In an attempt to elicit comment on this concept, the OCC recently issued a risk-based capital proposal, which is similar to proposals issued by the Federal Reserve Board and the FDIC. In the proposal, standby letters of credit, loan commitments, and note issuance facilities are incorporated in the formula for required capital.

6. Q. As you know, national banks are not allowed to invest in junk bonds -- that is bonds below the top four investment grades. Do you think this is a sound limitation, or do you favor its repeal?

Would you favor a similar prohibition on savings and loan associations?

A. We do not favor the repeal of the prohibition against national banks investing in bonds below the top four investment grades at this time. Without adequate safeguards in place to protect against the high-risk nature of these securities, such investments would not be a prudent banking practice. They should probably be prohibited for savings and loan associations as well.

7. Q. As you know, legislation has been introduced to authorize a new kind of bank called a Consumer Bank. Consumer banks would have more limited powers compared to commercial banks and would not be subject to certain restrictions on branching and ownership.

Does the Administration support the enactment of legislation authorizing consumer banks?

(follow-up) Isn't the concept of a consumer bank a major step backwards from the trend of financial institution legislation over the last 20 years during which time we have gradually eliminated artificial distinctions among different types of financial institutions? With the consumer bank concept, would we be moving away from generalized powers and back towards specialized powers?

A. Consumer banks, or nonbank banks that do not engage in commercial lending, are legal under existing law. So, in our view, legislation authorizing them is unnecessary. This aside, we believe that nonbank banks (including consumer banks) were conceived, and have been used, as a means for bank holding companies and other organizations to bypass certain banking restrictions that have impaired their ability to respond to changes in the marketplace. In view of this, we believe that it would be both more sensible and expedient for Congress to grant financial institutions needed flexibility through fundamental reform of our banking statutes. Then, each participant would be able to establish its own niche, or select its own combination of products and services which it believes it can best provide.

We would agree that the concept of limited-purpose institutions is inconsistent with the trend towards broader and more diverse powers for financial institutions -- a trend induced by the need of institutions for more flexibility to deal with increased economic volatility and changes in technology and demographics. However, the evolution of consumer banks has no doubt been due less to the desire of institutions to provide a specialized service -- consumer banking -- than it is to the quest of bank holding companies for more geographic flexibility, and to nonbanks' desire to provide otherwise prohibited banking services. In our view, it would be more appropriate to provide more flexibility for banks to expand geographically and nonbanks to have affiliations with banks. Then, if consumer banks arise, we can be assured that they are responding to a market need for specialization, rather than to legal restrictions.

8. Q. As you know I have been a strong advocate of strengthening the capital requirements of our large money center banks in light of their exposure on their international loans. Some of these banks are complaining that such a policy handicaps them in competing with foreign institutions and also prevents them from making needed new loans to the debtor nations.

Can you comment on the merits of such complaints and the implication that we may be entering a new era of competition in laxity - this time at the international level?

A. We share your concern about adequate capitalization of all banks, including the large multinationals. In fact, in early 1985, under the authority of the International Lending Supervision Act of 1983, the three federal banking agencies imposed a uniform minimum capital-to-asset ratio for all banks. This action involved an increase in minimum capital requirements for large banks, which has resulted in steadily rising capital levels at those banks.

We view that recent capital regulation as an interim step, and are now developing a risk-based capital standard. Under our proposal, which we recently issued for public comment, capital requirements would be revised to more explicitly account for the riskiness of each bank's assets, both on and off the balance sheet.

We also share your concern regarding the effect of capital requirements on the competitiveness of banks, both domestically and internationally. We believe a risk-based capital system will improve the ability of banks to compete, because they will face reduced capital requirements for lower-risk assets.

Moreover, bank supervisors world-wide are recognizing the need for adequate capital, commensurate with the risks banks take. Rather than competition in laxity, there is a cooperative effort to move toward uniform capital standards, in recognition of the internalization of financial markets and the growing consensus in favor of risk-based capital.

DEPOSIT INSURANCE REFORM AND RELATED SUPERVISORY ISSUES

PART II

THURSDAY, MARCH 13, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Riegle, and Dixon.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order. Today, we conclude the series of hearings on the Federal Deposit Insurance System. During this series, we have had eight hearings directly relating to deposit insurance in the forum related to supervisory issues.

In addition, we had had eight hearings which indirectly dealt with the issues. Three hearings on farm bank matters and two hearings dealing with the internationalization of capital markets, and 3 days concerning the effect of H.R. 3838 regarding the safety and soundness of financial institutions.

We've been exploring ways to improve the efficiency and fairness of the insurance system that was created more than 50 years ago. For the most part, the system has performed very well. Depositors have been protected from bank failures, disruptions have been minimized both in failed banks and in communities which they serve. And confidence in the banking system generally has been maintained.

Nevertheless, today's marketplace has changed very drastically since the creation of the Federal Deposit Insurance System.

Therefore, an overview and revision of that System is necessary to ensure the safety and soundness of our banking environment in the future.

At the conclusion of today's hearings, the committee will begin looking at specific legislative recommendations to modernize the deposit insurance mechanism, thus better reflecting today's marketplace needs.

As I indicated last July 23, when we began this oversight exercise, we will begin and end the hearings with the Chairmen of the respective insurance funds. At the time, we didn't know who they would be, with the exception of one, but we've had changes in the Comptroller of the Currency and in the Chairman of the FDIC.

But we are happy to have Bill Seidman, Chairman of the FDIC, and Edwin Gray, Chairman of the Federal Home Loan Bank Board before us this morning.

Before I turn to you gentlemen, I would like to turn to Senator Proxmire to see if he has any opening remarks he wishes to make.

OPENING REMARKS OF SENATOR PROXMIRE

Senator **Proxmire**. Thank you, Mr. Chairman. I do have a very brief opening statement, particularly directed at Mr. Gray. I'm going to have to leave then; I'll try to come back.

Mr. Gray, the current report of the President's Council on Economic Advisers seems to question the need for a savings and loan industry at all. Let me read from it. I quote:

> It may be appropriate to reconsider the wisdom of designating limited purpose lenders, including mortgage lenders. Commercial banks have been very active in mortgage lending. Their activity plus the success of firms in the secondary market for mortgage makes clear that mortgage lending does not require a separate subsidized financial sector.

Now, we've heard this may be the unwritten, secret agenda of the administration, to dismantle the thrift industry and rely exclusively on commercial banks.

I hope you can give us some insight into this, whether this is the Treasury-White House game plan with the thrift industry as far as you know, or not. You're the principal regulator we have in that industry, and you can tell us.

Thank you.

The **Chairman**. Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman. No statement.

The **Chairman**. Senator Cranston.

Senator **Cranston**. Thank you. I do not have a statement.

The **Chairman**. Senator Mattingly.

Senator **Mattingly**. Thank you, Mr. Chairman. I do not have a statement.

The **Chairman**. Mr. Gray.

STATEMENT OF EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. **Gray**. Thank you very much, Mr. Chairman and distinguished members of the committee. I received your invitation to discuss developments in the Nation's thrift system and initiatives the Bank Board is pursuing to strengthen that system.

I want to take this opportunity, as I have done during so many occasions during my tenure as Bank Board Chairman, to again emphasize the importance to the industry I regulate of the passage of the historic Garn-St Germain Act, which you, Mr. Chairman, and your colleagues on the committee developed back in 1982.

That legislation continues to serve as the basis of a long-term thrift industry recovery with the diversification options it provided, while at the same time assuring that the principal role played by the industry would remain in housing finance, which is the underlying premise for the maintenance of a separate and integral statutory thrift system.

REFLECTION OF THE FHLBB

In their wisdom a half century ago, the founders of the Nation's thrift system created an integral deposit insurance, credit, and regulatory structure under a single Board of Governors whose responsibilities encompassed these three key functions.

That structure, which, to this day, remains unique to the Nation's system of thrift depository institutions, has served our Nation very well down through the years. I can think of no public-private sector partnership which has consistently worked so well to advance national public policy goals as the system we know as the Federal Home Loan Bank System.

Three of its component parts fit hand in glove with each other to support the fourth component—America's savings institutions, whose principal purpose is to enhance home ownership opportunities. While all four component parts are mutually dependent on each other it is the fourth component of the system—our thrifts—which provides the financial support for the rest.

It is the member thrift institutions in this system which own stock in the Federal home loan banks, pay insurance premiums to the FSLIC and underwrite the financial needs of the regulatory functions. What the system amounts to then is a self-regulating public-private sector partnership whose overall financial resources are extensive indeed. And, we intend to keep it that way.

I say this because, as the written statement I sent you makes clear, we on the Bank Board believe we have fashioned an exciting and innovative financial approach which addresses the need for a long-term recapitalization of the FSLIC fund, and accomplishes it free of any taxpayer-provided appropriations.

The outlines of the basic approach that we have developed—which include a number of optional financial courses of action—are the product of months of exploratory work by our Federal home loan bank presidents and their key staff.

We at the Bank Board not only have meshed our efforts with these bank presidents on a continuing basis, as you would expect, but we also have worked closely with Under Secretary of the Treasury, George Gould, and his staff on a range of thrift and FSLIC-related issues since last fall.

Under Secretary Gould met with the Bank Board and the Federal home loan bank presidents at our February meeting in Cincinnati where all of us shared our thoughts about how the resources of the FSLIC could be strengthened, with special emphasis on the manner in which the Federal home loan banks might appropriately assist in this endeavor.

Further refinements in the basic outline of the financing package have been detailed in the recapitalization section of my written statement. On a conceptual level, a meeting of the minds has occurred between the Bank Board and the Treasury on this matter. It is my understanding that Treasury plans to refine the options and expedite the review process in the administration. I am very hopeful we can move forward together with proposed legislation to accomplish the basic approach to recapitalization I have outlined within a month.

WOULD NOT REQUIRE TAXPAYER FUNDS

Again, the recapitalization approach I have outlined would not require taxpayer funds. It would utilize the retained earnings of the Federal home loan banks, and the future share of earnings in a very effective manner by leveraging them through capital market borrowings, gradually over time, thus providing the FSLIC an additional $8 to 10 billion over the next few years. The borrowings would be repaid over a long period of time out of a portion of the earnings streams of the Federal home loan banks and a portion of premium assessments received by the FSLIC. To repeat, all of the stock of the Federal home loan banks is owned by thrift industry member savings institutions. The 12 banks' assets total $112 billion. In the aggregate, they represent one of the strongest banks in the world, with a 9-percent capital ratio. Their loans to member savings institutions are so well-collateralized, they have never lost a penny on any loan, to my knowledge, in their half-century of existence. Our recapitalization approach would never touch their primary capital, only retained earnings, and a portion of future retained earnings.

The overall recapitalization program—which, again, would rely solely on the resources of the thrift industry itself, including the industry-owned Federal home loan banks—would add up to a $22-billion program. We believe this would be adequate for the FSLIC to resolve all of its problem cases over the next 5 years.

What is more important is that this approach to dealing with our caseload of failed and failing institutions would enable the FSLIC to resolve them much sooner and avoid additional costs associated with leaving them open longer.

We have little choice in the matter now because our current, ongoing resources at the FSLIC are quite limited and, finity relative to the magnitude of costs we will need to resolve troubled thrift industry cases, as you know.

In the written statement, I point out that recapitalization of the FSLIC, important as we believe it is, must be tied to regulatory and statutory changes which very significantly reduce the likelihood of additional continuing problems, such as those we're wrestling with now.

The statement goes into a number of key regulatory initiatives we intend to pursue, as well as recommended statutory changes.

Quite clearly, on the regulatory side, thrift capital requirements must be phased upward over 5 or 6 years to 6 percent. Additional reserve requirements on risky loans and investments need to be required. We also are developing a range of options intended to strongly encourage thrifts to reduce asset and liability, and duration mismatch in their portfolios, so they will not find themselves in the same terrible 1981–82-type crisis, which befell them and the FSLIC when interest rates in that period surged upward.

The prepared statement lists the salutory effects which have already been achieved through adoption of last year's net worth regulation, and the direct investment regulation, as well as a number of others.

Several of the most important statutory changes we need are in the enforcement area. We are seeking specific statutory authority to define, by regulation, what constitutes an unsafe and unsound practice, pursuant to the National Housing Act. We also seek a key statutory change which would remove the word "substantial" as modifier of the term "dissipation of assets" in current law, in connection with our authority to issue temporary cease-and-desist orders.

Such legislation would enable the Bank Board to move to halt more quickly safe and unsound practices and take control of institutions sooner, before they cause significant losses to the FSLIC.

My prepared statement contains numerous other suggested statutory changes. We also strongly support extension of the Net Worth Program, and urge extension of titles I and II of the Garn-St Germain Act.

Finally, let me say that if the remedial approach we are proposing to address the FSLIC challenge is adopted by the Congress in an expeditious manner—which would, for all practical purposes, put that issue behind us—I can be very bullish, indeed, on the future of the Nation's thrift system. I believe this initiative would restore fully the public confidence Americans deserve from the system. In my view, all of us now have a real opportunity to make this happen soon.

GREAT PROFITABILITY FOR THE S&L'S IN 1985

Interest rates are at levels where the industry can rebuild its overall financial strength and bring about the restructuring necessary to accomplish this. Last year was one of great profitability for the industry, and I would expect a repeat of this in 1986.

As my prepared testimony suggests, the GAO report, which the committee discussed earlier over on the House side in a hearing last week, was out of date because of the improving news on thrifts in 1985. The dark picture that that report painted was seriously flawed, in our view.

Still, much does remain to be done. But the change in mentality among thrift industry leaders over this last year, and their apparent willingness to support continuing injections of operating discipline by the regulators into the industry out into the future bode well for continuing progress.

Thank you very much. I'll be pleased to try to answer any questions you may have.

[The complete prepared statement follows:]

STATEMENT OF
EDWIN J. GRAY, CHAIRMAN
FEDERAL HOME LOAN BANK BOARD
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATE SENATE
MARCH 13, 1986

Mr. Chairman and members of the Committee:

Thank you for giving me this opportunity to bring you up to date on the problems facing depository institutions insured by the FSLIC, and the FSLIC itself, and to tell you of our past efforts and present proposals to address these problems. We at the Federal Home Loan Bank Board very much appreciate your willingness to work with us in this matter.

I. INTRODUCTION

In 1985, savings institutions achieved their highest aggregate return on assets since 1979, and in the process earned net income four times that of just one year earlier. Most significantly, the thrift industry sharply reduced its growth rate from the unsustainable and unsound pace of 1984, largely in response to the Board's new net worth regulation. Liability growth slowed from more than 19 percent in 1984 to 8 percent in 1985, with the reduction concentrated in more costly and volatile liabilities. Thus, the Bank Board's efforts to keep thrift growth in line with the industry's real capital level is now bearing fruit.

The regulatory net worth ratio of the industry increased during 1985 by approximately 13 percent -- from 3.88 percent to 4.38 percent--as a result of improved profitability, sale of stock and subordinated debentures, and the issuance of net worth certificates.

Even under last year's favorable operating environment, however, a minority of the industry -- some 15 percent -- continued to experience operating losses, and a much smaller number of institutions encountered serious solvency problems because of unsound lending and investment practices, deriving in large part from earlier excessive deposit growth. This kind of growth had fueled such practices because too much high-priced money was chasing too few good assets.

Nevertheless, the recent report on the state of the FSLIC fund by the Government Accounting Office (GAO) drew conclusions which seriously overstated the nature and the magnitude of the problems facing the FSLIC. In Appendix A is a copy of a letter I wrote refuting the conclusions of the GAO Report. The GAO report implies that over 42 percent of the industry is likely to require some form of FSLIC assistance. In the Bank Board's view, the GAO seriously distorted the magnitude of the problem when it jumped to this faulty conclusion.

The GAO report is based on an analysis that only takes into account GAAP net worth. While the current level of net worth is important, an equally important factor is an institution's future earning potential. To suggest that all GAAP-insolvent institutions will require FSLIC assistance ignores future earning potential and thus tends to dramatically overstate the size of the problem.

Our analysis of the numbers in the GAO report indicates that less than 8 percent of the industry should be considered potential problem cases for the FSLIC. This number is significantly less than the 1,300 institutions with assets of $433 billion, or 42 percent of industry assets reported in the GAO document.

Another problem with the GAO report is its failure to examine the resources available to the FSLIC, including those of the Federal Home Loan Banks. The report also does not acknowledge that various actions can be taken to replace current managers of weak institutions, thereby arresting their deterioration and the resulting threat to the FSLIC. Indeed, the report fails to include the significant lines of credit available to the FSLIC.

As you know, the decline in the working reserves of the FSLIC has continued. At the end of 1985, the total insurance reserves were approximately $6 billion and the ratio of reserves to members' deposits remained at about 0.72 percent. After subtracting the projected costs of resolving a growing caseload of insolvent institutions, the usable resources of the fund are significantly less than the FSLIC's book reserves. This situation will be exacerbated because of the number and projected costs of cases expected to arrive on the FSLIC's doorstep in the near and foreseeable future. Book-reserves are projected to decline, and the true level of usable reserves of the fund will also decline. This continuing movement seems inexorable, absent the remedial approaches I will discuss.

The number of FSLIC problem cases and the estimated costs to the FSLIC of resolving them have been, and continue to be, of serious concern to the Bank Board.

Therefore, the overriding concern of the Bank Board is that an acceptable long-term replenishment of the FSLIC insurance fund be found. In other words, the fund must be recapitalized. To do this, the Bank Board, the Administration, and the Congress must join forces to attack on two fronts the problems the FSLIC faces. First, the insurance fund must be recapitalized to provide the resources necessary to resolve problem cases in as timely a manner as possible. Second, regulatory and legislative changes must be made to reduce the likelihood of additional, continuing problems in the future.

II. RECAPITALIZATION

One of the major elements in solving any complicated problem is to come to grips with the size of the problem. Much debate has focused on this issue including testimony last week on the GAO report. The bulk of that hearing was devoted to responding to the GAO's overstatement of the problem and the flawed methodology contained in the report. Let me, for the record, clarify in detail the size of the problem, so far as the Bank Board is concerned.

There are currently 93 institutions with assets of $41.4 billion in the FSLIC caseload. These include 31 institutions in the management consignment program (MCP) and two Phoenix cases. Both the management consignment program and the Phoenix program allow FSLIC to warehouse problem cases until an acceptable solution can be found. Thus, while these programs provide a temporary answer, they do not provide long term solutions. The MCP program, which I will describe more fully later on, simply places FSLIC cases in a holding pattern awaiting ultimate resolution.

In addition to the 93 cases I've described, the professional staff of the Bank Board's Office of Examination and Supervision (OES) has reviewed institutions on a case-by-case basis and has identified 81 institutions with assets of $24.7 billion that are likely to require FSLIC assistance in the future. OES has also identified 42 institutions with assets of $14.2 billion that may fail in the future but whose resolution may or may not require FSLIC assistance. Thus, a total of 216 institutions with assets of approximately $80 billion will potentially require FSLIC assistance in the future. Another 69 institutions in the Bank Board's Significant Supervisory Institutions caseload, with $18.4 billion in assets, are not, at this time, projected to require financial assistance from FSLIC in order to achieve resolution.

The financial condition of the FSLIC depends critically on the number of cases that are resolved, and the cost to resolve them. Resolution costs vary depending on whether the institution under consideration suffers from an interest-rate-spread problem or has an asset-quality problem. For 1985, FSLIC has estimated that assisted mergers and acquisitions cost the FSLIC approximately 7 percent of a problem institution's assets. During the same year, liquidations cost approximately 29.3 percent of an institution's assets. Therefore, given its ratio of liquidations to assisted mergers in 1985, FSLIC estimates that resolutions in 1985 cost FSLIC, on average, approximately 14.5 percent of an institution's assets. This 14.5 percent multiplied by the $80 billion in assets held by the 216 institutions identified above, suggest that total resolution costs will run approximately $12 billion.

This $12 billion estimate, however, may be overly optimistic for two reasons. First, the 14.5 percent estimate for the weighted average cost of resolution does not include additional costs which may well be required to resolve the MCP cases. Since many of these are serious asset-quality cases, their ultimate cost of resolution will, in all likelihood, be higher than this average. Second, our FSLIC staff has already suggested that many of our future problem institutions are likely to be expensive asset-quality cases and therefore will be more expensive to resolve. Therefore, if one uses a 20 percent average cost of resolution to adjust for these factors, the estimated cost to resolve FSLIC's actual and potential caseload will more likely be in the $16 billion range.

This does not imply that FSLIC needs $16 billion immediately. Rather, the FSLIC will likely resolve all its known cases over the next three years. During this interim, other cases will inevitably arise. Thus, the resources that FSLIC will require over the next five years will include not only those necessary to cover known cases but also some resources to handle problem institutions which will end up on the FSLIC's doorstep. Our contingency planning provides for these uncertain costs by providing total resources of $20 billion or more.

In October of last year, I testified before the House Banking Committee and stressed my own belief that the FSLIC needed to be recapitalized. I noted then that there were three sources of recapitalization -- the Treasury, the thrift industry, or the Federal Home Loan Banks. At that time, I said I opposed -- and still do, of course -- recapitalization by the federal taxpayer. I said any recapitalization must be borne by the industry or the Federal Home Loan Banks. What I am proposing today on behalf of all three members of the Bank Board is a combination of both, since the Federal Home Loan Banks are wholly owned by member savings institutions.

All the stock of the FHLBanks is owned by the industry and the Banks are directed by regional boards made up of a combination of elected stockholders and Bank Board-appointed directors. As of December 31, 1985, the FHLBank System had $112 billion in assets and $10 billion in capital -- or a 9 percent ratio of capital to assets. Their balance sheets are composed of safe liquid investments and loans collateralized well above market value, primarily with residential mortgages. In 1985, the FHLBanks earned in excess of $1 billion and paid out close to $800 million dollars in cash and stock dividends. In short, the aggregate strength of the twelve Federal Home Loan Banks constitutes one of the largest and certainly safest banking systems in the world.

Last fall, I turned to our Federal Home Loan Bank presidents and their creative financial staffs to begin developing alternative ways in which they might help the FSLIC financially. Needless to say, they had to overcome a myriad of accounting, legal, tax, operational and financial obstacles.

The first such plan was developed by our Dallas Bank in October. Over the last few months, a variety of other worthwhile alternative approaches have been developed.

During this period, the U.S. Treasury Department began doing its own contingency planning regarding the FSLIC. I and my staff at the Bank Board have met on numerous occasions with Treasury officials over the past several months on thrift and FSLIC issues. Recently, representatives of a task force I appointed in early January, including a number of Bank Presidents and Bank Board staff, met with senior officials at the Treasury to mesh together our joint efforts. On a conceptual level, a meeting of the minds already has occurred among both groups. A variety of options have been developed from which a final joint proposal should emerge. It is my understanding

that Treasury plans to refine the options and expedite the review process within the Administration, and hopefully we can move forward together with legislation to accomplish recapitalization of the FSLIC within the next 30 days.

As I have already mentioned, FSLIC will need to spend approximately $16 billion over the next three years and up to $22.5 billion over five years to resolve problems. An infusion of approximately $8 billion -- together with the FSLIC's current reserves and income from regular and special premiums and investments -- appears sufficient to solve cases costing between $16-18 billion. An infusion of $10 billion could handle cases costing between $20-22.5 billion.

We have carefully analyzed the balance sheets of the Federal Home Loan Banks to determine the amount of resources which are available to aid FSLIC, without impairing the financial strength of the FHLBanks, in order to accomplish a recapitalization of the insurance fund. Since the FHLBanks are wholly owned by member savings institutions in their districts, the maintenance of their financial integrity is crucial to the membership if the FHLBanks are to continue to both lend funds at relatively low rates and to pay appropriate dividends. In 1985, the dividends paid by these Banks to their member institutions amounted to approximately 20 percent of the savings institutions industry's earnings.

The FHLBanks had total retained earnings of $1.8 billion and assets of $112 billion at the end of December, 1985. The FHLBanks -- in the more than half century of their existence -- have never sustained a loan loss. Their loans are so well collateralized they do not carry loan loss reserves. The other key component of our national thrift system, the FSLIC, was established to absorb the losses of the FSLIC-insured members of the FHLBank System. It seems reasonable to all three members of the Bank Board therefore, given both the strength of the FHLBanks and the needs of the FSLIC, that the current and future retained earnings of the FHLBanks could appropriately be leveraged in order to provide additional funds to the FSLIC to assist it in meeting its obligations over the next few years or so. Assuming earnings of $1 billion a year, funds represented by this earnings stream could provide approximately $200 million to $300 million per year to aid FSLIC without significantly reducing dividends to member institutions.

Two alternative means of using these retained funds are available. The funds -- including the $1.8 billion in the FHLBanks' retained earnings and a future share of earnings -- could be given to FSLIC to provide $3-4 billion over the next several years, or they could be leveraged through capital market borrowings to provide $8-10 billion. It seems far more reasonable to us to leverage the FHLBanks' contribution, and pay off such borrowings over a long period of time from the earnings streams represented by a portion of FHLBank earnings and a gradual decline in the level of premium assessments received by the FSLIC.

From our discussions with the FHLBank Presidents and Treasury officials, the Bank Board is united in agreeing that any approach of this kind to recapitalize FSLIC should consist of four steps. These are: (1) the issuance of debt; (2) the setting aside of funds to assure principal repayment; (3) the long-term payment of interest on the debt; and (4) the transfer of the proceeds to FSLIC, perhaps in the form of an equity investment. These four steps can provide FSLIC with upfront money that can be used to resolve cases sooner rather than later, and thus cut the fund's losses which otherwise would result from a deteriorating, more costly caseload.

The issuance of such debt by the Federal Home Loan Banks could be through regular FHLBank consolidated obligations, through special obligations for this purpose only, or through other market mechanisms. The regular consolidated obligation route is least desirable since the cost of all FHLBank debt could be increased if the market perceived additional risk to the FHLBanks. Special "revenue" bonds also are an option. Principal repayment would be assured through investment in some form of sinking fund. Interest payments could be passed through from FSLIC earnings. Other options are available to separate the perceived risk of the FHLBanks from the FSLIC. They also would utilize sinking funds and interest obtained from the FSLIC income stream. Such options could be designed to further reduce the market impact for FHLBank debt. It must be acknowledged that the Bank Board will under no circumstances consent to reducing the primary capital of the FHLBanks below its current limit of $8 billion.

The second step would employ future retained earnings of the FHLBanks to provide either a sinking fund or other options for repaying the principal of the debt issued for the benefit of FSLIC. The proceeds would be passed through to FSLIC. A trustee would be likely in any case. At current rates, the available funds in the FHLBank retained earnings accounts could be used to set up the principal repayment component of such a sinking fund. With the principal return assured, the only remaining concerns would be limited to interest repayments.

The third step is the actual payment of the interest on the debt obligation by FSLIC. If the FHLBanks purchase some form of stock or deposit instrument from FSLIC, dividend or deposit payments would have to be structured to cover interest expense. If the infusion to FSLIC was in the less desirable form of a loan, the interest paid on the loan by FSLIC would have to cover the interest payments to debt holders of the FHLBanks.

The fourth step in such a recapitalization would be the transfer of the proceeds from the FHLBanks to the FSLIC. As Treasury Under Secretary George Gould mentioned in his testimony before this Committee last week, the money could be provided in the form of loans, deposits, subordinated debt or preferred stock. This last option -- that of preferred stock -- is the most desirable. As a result of certain government accounting conventions, the addition of

debt or deposits to FSLIC's balance sheet would not increase its reserves. The purchase of preferred stock in FSLIC by the FHLBanks would increase FSLIC's reserves and therefore the amount of funds available for case resolution.

In any event, the funds to cover the debt interest must come from FSLIC and future FHLBank retained earnings. In order to service $8-10 billion in 20-30 year debt obligations, at projected rate levels, the FSLIC would utilize a portion of its investment income and regular premium income and the proceeds from a gradually declining level of special assessment income. With regard to the latter, under our current assumptions, the one-eighth of one-percent special assessment could either be retained in full for five to six years, or be phased out gradually over 10 years -- with a 10 percent reduction in 1987, a 25 percent reduction in 1988, a 40 percent reduction in 1989, a 50 percent reduction in 1990, and tapering down in the same manner over the last five years to zero. The latter alternative is our preferred approach because it is more sensitive to the large burden the special assessment places on healthy institutions over the next few years. The gradual phase-out of the special assessment would preserve the amount of funding required to develop the needed multi-billion dollar recapitalization of the FSLIC.

From Congress' point of view, the resulting approach would greatly strengthen public confidence in the thrift system by providing adequate support to the FSLIC to meet its obligations, as we and the Treasury see them. Providing that the preferred stock approach is utilized, such an equity instrument would not negatively impact the budget deficit, because this kind of equity investment would be made by the Federal Home Loan Bank System. The financial strength of the Federal Home Loan Banks would be maintained through the kinds of very strict financial-safeguards I have described. Although the Garn-St Germain Act authorized the Federal Home Loan Bank Board to direct the FHLBanks to assist the FSLIC, the recapitalization assistance approaches which have been developed would necessitate legislation to fully implement them.

From the thrift industry's perspective, the basic general approach I have outlined should accomplish three major goals. It would leverage, by a significant amount, the yearly insurance premium assessments paid by FSLIC-insured thrifts so that problem cases could be solved earlier at a lower cost, thereby limiting the future impact of more expensive losses on the FSLIC fund. It would provide needed resources to resolve many cases that are presently in a deferral mode, so that the high rates paid for deposits by these sick institutions would cease to disrupt the deposit market equilibrium for healthy institutions competing in their market areas. Finally, and very importantly, the approach all three Board members prefer is a phase-out of the one-eighth of one-percent special assessment, so that healthy members of the thrift industry would be able to see a "light at the end of the tunnel," and gradually get out from under the costly burden they must share.

In summary, a well-conceived and feasible set of options has been developed by the Bank Board and they are now being reviewed by the Treasury Department.

III. BANK BOARD RESPONSE TO EXISTING LEGISLATIVE PROPOSALS

A) EXPANDING ACQUIRERS OF TROUBLED THRIFTS

A basic Bank Board policy is to seek a wide variety of investors to bid on failing and failed thrifts to minimize expenditures for the FSLIC. We actively encourage commercial banks, industrial firms, insurance companies, as well as "nonfinancial" organizations to submit bids to acquire failed institutions under the bidding process established under the Garn-St Germain Act. With a single exception, any interested party can participate in that bidding process so long as it meets essential financial requirements, can demonstrate a good record, and show it is willing to play by our rules.

The single exception is limited only to those corporate entities whose activities are concentrated in a very significant way in investment banking -- that is to say, in the underwriting of, and marketmaking in corporate securities. The Bank Board adopted a policy of not permitting affiliations of thrifts and securities underwriting firms in the fall of 1983. We did so at that time because we believed, and still do, that the issue is significant enough to require full congressional policy regarding guidance to the Board. Nevertheless, since then, the Board has developed a "Chinese Wall" segregation-of-activities approach to securities underwriting affiliates of insurance companies, for example, which seek to acquire troubled thrifts. The Board takes the position that application of this particular approach should be exercised on a case-by-case basis, depending on various factors.

Some commercial banks have complained that they are not wanted as acquirers. That is absolutely false. We welcome them with open arms. However, we expect them -- and all other serious bidders -- to help us save the FSLIC money when they submit their bids.

Two difficulties the Bank Board faces in finding serious acquirers for its FSLIC cases are the poor asset quality of most troubled institutions and the high cost of the "hot" money funding their portfolios. These problems of poor asset quality and high liability cost have substantially offset the interstate franchise value of failed thrifts. The continued existence of the nonbank bank phenomenon also erodes the franchise value of such thrifts. We have never taken a position on the merits or demerits of nonbank banks, as such. Our concerns have been limited to the manner in which nonbank banks hinder entities from acquiring troubled thrifts because such entities have far less expensive access to nonbank bank franchises. The more the interstate franchise value of a failed thrift is offset by such "debits," the more the FSLIC must contribute from its own resources to resolve troubled cases.

When no acquirers can be found, the Bank Board has no alternative but to ultimately close a failed institution, and that is very costly, indeed. To strengthen the franchise value of FSLIC-insured institutions and stop this hemorrhage in the FSLIC's limited reserves by injecting sorely needed capital into the industry, legislation is urgently needed in three areas.

The first involves dealing with the nonbank bank issue. While it is impossible to precisely measure the impact the nonbank bank phenomenon has, and has had, on the FSLIC's ability to resolve problem cases, bidders who were willing to negotiate seriously to acquire a failed thrift to achieve interstate operating rights have largely disappeared. Again, they can now buy interstate operating rights far more cheaply by obtaining a nonbank bank charter.

The second needed legislative action is extension for three years of the emergency provisions of Titles I and II of the Garn-St Germain Act, particularly the net worth certificate program and the extraordinary acquisition provisions. The Board is very appreciative, Mr. Chairman, for the support you gave us last year on this matter. We hope we will receive additional support for extension of these provisions, which are absolutely critical to avert further serious erosion of the FSLIC's reserves. Through December 31, 1985, 115 FSLIC-insured institutions (85 federally chartered and 30 state-chartered) had issued or had outstanding net worth certificates totalling $210,575,000. Appendix B discusses in detail the value of the net worth certificate program and why it should be extended.

The third needed reform involves eliminating all bidding priorities established by section 123(a) of the Garn-St Germain Act. The Board believes increasing the flexibility of the FSLIC to negotiate emergency thrift acquisitions without those bidding preferences and procedures will result in two benefits. First, it will allow more creative solutions of benefit to the FSLIC. Second, it will encourage qualified and much needed investment capital sources, both in-state and out-of-state, to more actively participate earlier on in the restructuring of troubled institutions.

Section 123(a) empowers the FSLIC to arrange mergers of failed thrift institutions across state lines regardless of interstate branching prohibitions. However, it also requires the Board to give first preference to savings institutions from the same state. And if the qualified offer presenting the lowest expense to the FSLIC is from an institution that is not an in-state savings and loan holding company, additional offers are permitted from any such in-state offerer whose original bid was within 15 percent or $15,000,000, which ever is less, of the initial lowest acceptable offer. The Board believes this bias against out-of-state bidders often discourages them from participating in bidding conferences, thereby precluding potential offers presenting the lowest expense to the FSLIC from outside the home state of the financially distressed thrift. Again, this four-tier bidding procedure has perhaps had the unintended effect of slowing down the process of eliciting the best possible bids for troubled thrifts at the earliest possible time.

The Bank Board also believes that "tandem" restrictions placed on thrifts which would be acquired by bank holding companies -- restrictions which may be imposed by the Federal Reserve Board -- constitute an impediment to the FSLIC's efforts to attract such acquirers for failing thrifts. Perhaps, the authority to determine appropriate operating limits for thrifts owned by a bank holding company ought to be vested in the Bank Board, itself.

An emerging and very serious problem relating to the acquisition of troubled thrifts derives from the Tax Reform Act of 1985, recently passed by the House of Representatives. This bill, now being considered by the Senate, would repeal several provisions of the Internal Revenue Code (I.R.C.) that facilitate supervisory mergers and conversions of failing thrift institutions. These provisions of the Internal Revenue Code are: Section 368(a)(3)(D)(ii) (taxfree reorganization treatment of supervisory thrift mergers); Section 382(b)(7)(B) (net operating loss carryovers in tax free supervisory mergers); Section 597 (FSLIC assistance not taxable); and Section 593(e)(1) (no recapture of bad debt reserve when FSLIC assistance is repaid).

The Board urges the following with regard to these four provisions. First, the FSLIC tax provisions should be continued in effect and not repealed. Section 804(a) and (b) of H.R. 3838, which repeal the FSLIC provisions, should be rejected. Second, supervisory thrift mergers and conversions should be excepted from the proposed new revisions of restrictions on net operating loss carryovers under Section 382 of the I.R.C. (Section 321, H.R. 3838). Third, I.R.C. Section 265(1) should not apply to thrifts which receive FSLIC assistance. This I.R.C. section disallows deductions for expenses "allocable to" receipt of tax-exempt income. Section 804(c)(2)(B) of the House bill contains such a clarification, but only for 1981 through 1985. This provision of the House bill is sound, and should apply for the entire period during which the FSLIC tax rules are continued. Finally, the taxfree reorganization category should be updated to cover supervisory conversions as well as mergers of troubled thrifts.

Repeal of the FSLIC tax rules would have a devastating effect on the Bank Board's ability to arrange supervisory mergers. The practical effect will be to dramatically reduce the number of potential acquirers and increase the cost to the FSLIC for those entities still willing to acquire failed institutions. For example, in some recent negotiations, potential acquirers have asked the FSLIC to indemnify them for the increased tax liabilities that will arise if the merger and the FSLIC assistance become taxable. Furthermore, these transactions could become illegal because the cost of assistance could exceed the cost of liquidation. In such circumstances, the current law requires the institution to be liquidated.

We believe that if repeal of the provisions I have described were to occur, acquisitions of failing institutions would come to a screeching halt. This would eliminate any purported increase in tax revenues. Given the enormous strains on the FSLIC fund, we believe these portions of the the Tax Reform Act are "pennywise and pound foolish." Although the House tax staff estimates increased revenue of $1.3 billion, we find this figure completely illusory. In fact, liquidating payments would increase and, since the full faith and credit of the United States implicitly back the FSLIC insurance fund, repeal of these critical provisions would ultimately cost the Treasury more than the cost of continuing the existing tax rules.

We believe it is absolutely critical to eliminate these provisions from the Tax Reform Act entirely. My fellow Board members and I have expressed these concerns to the appropriate Committees. We will continue to press for preservation of the current tax treatment to protect the FSLIC's resources.

IV. BANK BOARD INITIATIVES TO STRENGTHEN THRIFTS AND THE FSLIC

Over the last year, the Board has taken a number of steps to improve industry health and the condition of the FSLIC.

A. IMPROVING THE EXAMINATION AND SUPERVISORY PROCESS

The Bank Board has made a herculean effort within its limited resources to address the examination and supervision needs posed by the thrift industry. On July 7 of last year, we transferred our field examination function to the twelve Federal Home Loan Bank districts, a move which has enabled us to pursue the process of building a better trained and more effective field examination force. Within less than six months of that transfer, the number of examiner professionals in the twelve districts was increased from 747 to 1,003, or 34.3 percent. This transfer of the examination function has enabled our Principal Supervisory Agents to hire more and better qualified candidates than had been previously possible. The trend will continue. We will hire 250 more examiners by June 30, 1986, and we expect to have more than 1,500 field examiners in the field by the end of 1986.

In addition to increasing our field examination force, we have also doubled our supervisory staffs in the districts in the last eighteen months. We have directed the Principal Supervisory Agents to continue this buildup.

As a result of the continuing increase in our examination and supervisory forces in the Federal Home Loan Bank districts, the Board has established what amounts to a national field examination and supervisory strike force which can be assigned to meet special, critical needs in any of the districts.

Since the Board delegated the field examination functions to the Principal Supervisory Agents of each district, and while we continue to delegate further supervisory functions to the Banks, it is critical that the Board continuously review, monitor, and closely oversee the effectiveness of examination and supervision.

In this regard, the Board has begun to put in place, through a system-wide task force, the best and most modern computerized systems both for examination reports and supervisory actions, and to computerize input from each institution for the monthly and quarterly financial data required by the Board. We intend to put onto computer, on a continuing basis, all examination reports and the supervisory follow-up to examination reports, so that the Bank Board can more effectively audit and oversee that joint field function in Washington. The computerized tracking and information system for examination and supervision, integrating the Board's central financial reporting system, will be a needed, additional tool for monitoring and evaluating the Federal Home Loan Banks' compliance with Board policies and delegated responsibilities. Moreover, I have asked Board Member Mary Grigsby to lead a task force to establish a post-decisional or post-action audit review process for the Bank Board utilizing the new computer systems. She has reported substantial progress in this area.

B. CREATION OF THE OFFICE OF ENFORCEMENT

Improving and increasing our examination and supervision staffs is only one part of the total enforcement emphasis of the Bank Board. In November 1985 the Bank Board created a new and separate Office of Enforcement, comprised of the staff of the former Division of Enforcement within the General Counsel's Office. Shortly thereafter, the Office was authorized to double its size in 1986. This reorganization allows us to act even more quickly and aggressively to halt abusive practices which threaten the FSLIC fund. The increased volume of formal enforcement activity is a direct result of the increased level of examining and supervisory personnel, as well as a series of supervisory directives the Board sent in 1985 to impress upon all supervisory personnel at the twelve Federal Home Loan Banks the need to vigorously enforce all laws and regulations. In particular, the Board directed that immediate and effective supervisory action be undertaken for all unsafe or unsound practices and that immediate referrals be make to the Office of Enforcement for all material violations of laws, regulations, and agreements. These directives have already resulted in substantial increases in both informal supervisory actions and formal enforcement actions.

C. FEDERAL ASSET DISPOSITION ASSOCIATION

Another significant initiative in 1985 was the formation in November of the Federal Asset Disposition Association, or FADA, frequently termed in press reports the "406 Corporation." The FADA is a wholly owned subsidiary of the FSLIC, which will manage and dispose of assets received by the FSLIC in case resolution actions. Only a few weeks ago, the FADA's board of directors selected a highly qualified chief executive officer who is now gathering the staff necessary to begin the FADA's operations.

There has been much speculation and misinformation about the Bank Board's plan for the FADA. Let me set the record straight. Simply put, the FADA will be a nonexclusive contractor for management and disposition of FSLIC assets. While this function is now hampered by restraints on FSLIC staffing and resource allocation, creating of the FADA should dramatically change this situation. The FADA will be able to rapidly match hired talent to specific asset management problems, maximizing and accelerating the return of cash to the FSLIC. The FADA is just another refinement by the Bank Board in fulfilling its obligation to protect FSLIC resources by operating in an efficient and cost-effective manner, prudently using premium dollars to resolve FSLIC problems.

D. MANAGEMENT CONSIGNMENT PROGRAM

The Management Consignment Program (MCP) is a new tool used by the Bank Board for containment and evaluation of problem institutions. It is also meant to minimize the FSLIC's eventual solution costs. The program has been most useful thus far in handling large, troubled institutions whose bad asset problems have surfaced but not been fully defined. Assets and liabilities normally are passed through a receivership to a federal mutual structure to keep them in an operating entity. Day-to-day supervision is delegated to the Principal Supervisory Agent (PSA) in the relevant Federal Home Loan Bank district. The MCP entity operates under the watchful care of a highly qualified management group hired by the new institution with the PSA's approval, and with a board of directors of the MCP approved by the Bank Board.

The principal advantage of the MCP is that it permits rapid supervisory action without the necessity of a final FSLIC case resolution through sale or liquidation, terminating behavior that brought the institution into insolvency while allowing time for a measured unwinding of affairs and close examination of the assets. Such a program also appears to stabilize the deposit outflow at each institution. Each MCP participant is in a holding pattern, with expert management imported from successful members of the thrift industry attempting to unwind its affairs. MCP institutions are usually not immediately marketable, largely because of unknown asset quality or litigation in progress. Orderly marketing or rehabilitation eliminates more costly liquidation action, and the entire process conserves the FSLIC's resources. Because many MCP institutions are paying high rates for funds to attract and maintain deposits, the staff is exploring ways in which lower cost funds from the FHLBanks might be utilized to reduce the cost of money to these institutions, and therefore reduce the pressure on healthier competitor institutions to pay higher rates than necessary.

II. REGULATORY ACTIONS

In 1985, the Bank Board took several historically unprecedented and critically important actions to reduce the risk exposure of the FSLIC by strengthening industry capital positions and providing for better monitoring of thrifts' condition.

The Board amended its net worth regulation to require thrifts to earn their growth: that is to say, to correlate liability growth to net worth. The regulation also began the phase-out of certain regulatory accounting techniques that had previously overstated -- that is to say, distorted -- net worth levels.

The Board also adopted a direct investment rule, which requires prior supervisory approval for investments in equity securities, real estate, and service corporations exceeding certain threshold levels tied to an institution's net worth.

The revised net worth requirements had a significant effect on industry operations last year. Overall growth in liabilities dropped from 19.4 percent in 1984 to 7.9 percent in 1985, as managers conformed to the new net worth requirements. Moreover, growth rates were reduced most sharply by institutions with low net worth ratios. During the first three quarters of last year, growth in liabilities of institutions with net worth ratios of less than 1 percent was at an annualized rate of minus 4 percent, whereas it had been 21 percent in the comparable period a year earlier. The growth rate for firms with net worth ratios in the 1-3 percent range dropped from 26 to 4 percent. On the other hand, the growth rate for firms with net worth ratios above 5 percent dropped less, from 13 to 11 percent.

With regard to the requirement for added net worth based on direct investment, during the third quarter of last year, 67 firms were required to increase their net worth by an aggregate of $207 million because of the new requirement. We anticipate continued significant improvement in the industry as the result of both regulations.

The Board also adopted a final regulation on the classification of assets. The prior classification system did not adequately identify credit weakness in commercial loans, ADC loans, and construction loans because payment schedules and other indicia of "current" status are often of a different nature than such loans. The regulation applies to all loans except consumer loans and home loans.

Through this regulation, the examination and supervision process may now classify problem assets as "substandard," "doubtful," or "loss." When an examiner determines that an asset has specific weaknesses, he or she may recommend that the asset be classified as "doubtful" or "loss," and the supervisory agent will determine the amount of loss reserve. Depending on the Principal Supervisory Agent's determination, such problem assets may ultimately require establishment of a specific reserve. The reserves are drawn from the institution's net-worth accounts and thus lower its regulatory net worth. "Substandard" assets are treated as scheduled items, increasing the institution's minimum net worth requirement.

The classification of assets regulation closely parallels the classification method long used by the federal banking agencies and enhances effective supervision by providing thrift examiners with the means to identify and address credit weaknesses in assets.

In another action, the Bank Board moved to differentiate more accurately for reporting purposes between acquisition, development, and construction -- or ADC -- loans and direct equity investments. Many ADC equity investments have been accounted for as loans, and poorly underwritten ADC loans represent one of the major catalysts of FSLIC problems. The portfolios of most of our problem FSLIC cases are strewn with ADC direct investments, often camouflaged as ADC loans gone sour. In reviewing supervisory cases I have observed that many of our troubled major loans contain virtually no equity from the builder or developer: only the insured institution making the loan is at risk.

The industry's general, standard loan-to-value ratio of 10 to 20 percent equity for the typical home loan stands in sharp contrast to the minimal or nonexistent equity participation of builders and developers. The disparity is even more disturbing if one considers that the underlying collateral in the homeowner loan is relatively liquid and the debt service is soundly based on the homeowner's wages, as opposed to the illiquid and speculative nature of ADC loans.

To halt these egregious investment practices, the Board adopted an accounting policy that insured institutions are expected to apply standards of the American Institute of Certified Public Accountants which describe factors to be considered when determining whether a transaction characterized as an ADC loan is, in substance, a loan or a real estate investment or joint venture. The staff is currently considering the suggestion of our supervisory agents and others that we establish loan-to-value limits on ADC loans. Staff also is looking at a number of other ways to modify and very significantly tighten up the Board's loans-to-one-borrower requirements.

In order to improve the FSLIC's ability to trade franchise rights for assistance with its problem cases, the Board has proposed two regulatory amendments affecting interstate branching by federal saving and loan associations. First, a limited regulation would encourage competition in the District of Columbia and contiguous states and improve the competitive position of federal associations based there by (1) permitting federal associations based in the District to branch in either Virginia or Maryland, but not both, and (2) permitting a federal association based in Virginia or Maryland to branch within the District.

The second proposal is more far-reaching, affecting both branching and acquisitions. It would provide, with respect to branching across state lines, general parity for a federal association with state-chartered thrift institutions of the state in which the federal association's home office is located. Accordingly, a federal association located in a state granting to its thrift institutions "regional compact" or "reciprocal" branching rights could exercise the same rights as such state institutions. A federal association in a holding company structure could also exercise such "regional compact" or "reciprocal" rights, but only if no other FSLIC-insured institution within that structure possessed or exercised rights of this kind.

The second proposal would also break new ground in branching associated with acquisitions of failing FSLIC-insured institutions. The present policy allows a federal association to branch in a state other than its home state if it acquires a failing thrift in that other state. The proposal, however, would also permit, in selected FSLIC cases, "regional" branching rights to be obtained. A federal association acquiring a failing institution could be permitted to branch within as many as three states in addition to the state of the failed thrift or within a region defined by state laws on "regional compacts." The proposal should not be read as signalling a move by the Board toward unrestricted branching, even in supervisory cases.

Staff is also developing a regulatory proposal that would generally prohibit, or significantly limit, the use of noncash assets as contributions to net worth for facilitating the merger of institutions. Staff believes that such a regulatory change will better protect the FSLIC in the long run since noncash asset transactions are difficult to value as capital contributions.

In addition, staff is developing a proposal to address concerns that current liquidity requirements fail to reflect today's financial realities and that revision could be accomplished by establishing a liquidity coverage index to reflect an institution's ability to meet commitments and withdrawals. In other words, an institution's liquidity requirement would be based on its liquidity coverage index.

We are also exploring new ways to more effectively deal with nationwide lending, especially in the loan participation area where there have been many significant losses to institutions and, in too may cases, to the FSLIC itself.

Finally, staff is pursuing the final stages of another major regulatory initiative to further enhance the financial condition of the industry and ameliorate the strains on the FSLIC fund. The current minimum net worth requirements for thrift institutions are set too low either to adequately absorb significant losses or deter inordinate risk-taking. The preparation of options to increase the capital level of the industry and link capital requirements to both interest-rate risk and credit risk include:

-- Gradually increasing required thrift capital levels to 6 percent over a five to six year period;

-- Accelerating the phase-out of, or expediting the elimination of distortive effects of five-year averaging in calculating net worth;

-- Establishing risk-sensitive reserve requirements to take into account the risks associated with activities such as direct investments, acquisition, development, and construction loans; non-residential construction lending and commercial real estate loans; and

-- Linking capital requirements to asset-liability maturity and duration matching criteria and the risk-reducing effects of high-quality, maturity-matched traditional housing investments.

It is the Board's intention to move the industry generally -- in a gradual, phased manner -- closer to GAAP accounting standards.

F. COMPENSATION AND BENEFITS CONSTRAINTS

The Bank Board is plagued by recruitment and retention problems. Competitive disadvantage with the private sector will probably always be present, but the Board is also suffering severe competitive disadvantage vis-a-vis the other financial regulatory agencies.

The Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency have compensation and benefit flexibility which is beyond the reach of the Bank Board. That flexibility enables those agencies to offer employment packages comparable to those of many private sector enterprises. As a result, the Bank Board has been at a severe double disadvantage in competing for badly needed top talent.

The key to the flexibility of the other agencies is exemption from the Classification Act rooted in their enabling legislation. Although they generally follow the salary grades and pay ranges of this Act, our sister agencies have freedom to fix compensation of, and provide salary enhancements and benefit programs for, their employees as they deem appropriate. The Bank Board is denied such independence by a previous interpretation of the Office of Personnel Management that the Bank Board is subject to the Classification Act.

We have requested an administrative determination exempting the Bank Board from the Classification Act and related compensation regulations from the Office of Personnel Management. I hope the Board will not be forced to request legislation to ensure parity between the Board and its sister regulatory agencies in this regard.

G. APPLICATIONS TIME CLOCKS

On January 15, 1985, the Bank Board implemented a FHLBank System-wide new computer-based applications tracking system intended to reduce to a minimum the time required for processing all types of applications filed with the Board. More than 85 percent of all decisions regarding various thrift institution applications has been delegated to the Principal Supervisory Agents in the twelve FHLBank districts.

Under the new system, the Board established a series of stringent intermediate and final time deadlines for Board or Bank action on each different type of thrift application. The Board's Office of District Banks monitors the actual processing of applications to ensure that work is completed on schedule. In addition, the Board established a review committee, headed by Board Member Mary Grigsby, that reports monthly on the Board's and Banks' performance in meeting the prescribed deadlines, and also identifies causes of and remedies for any persistent processing failures.

During 1985, the diligent enforcement of the time clocks, along with the review committee's monthly reports, helped reduce applications processing time substantially by year-end. The Board expects to achieve further reductions in processing time in 1986.

H. THE MUTUAL TO STOCK CONVERSION PROGRAM

The Bank Board has given high priority to administration of the mutual-to-stock conversion program under which FSLIC-insured thrifts may convert from the mutual to stock form of ownership. Mutual-to-stock conversions have proven to be a unique and extremely effective means of infusing needed capital into the thrift industry, and the capital raised through conversions -- nearly $5.5 billion --now equals approximately 12% of the aggregate net worth of the entire industry. I have attached to my testimony as Appendix C a table depicting the number of applications for conversions filed, approved and completed, for each year since 1972. The last column reflects the amount of capital raised by the converting associations. Notably, nearly $5 billion of the approximate $5.5 billion total has been raised during the past three years. This figure reflects the key role that conversions can play in bringing new capital to the thrift industry. In addition, Appendix D illustrates the number and asset size of institutions that have converted from the mutual to stock form of ownership since 1985.

Although the Bank Board adopted regulations to govern its mutual-to-stock conversion program in 1974, the Board continually has revised these regulations to meet both its goals and the industry's needs by providing substantial flexibility to the conversion process, and greatly expanding the industry's potential capital sources.

During 1985, the Board adopted certain amendments to the conversion regulations which streamlined the conversion process in significant areas. First, while affording suitable recognition of the rights of mutual accountholders, the Board adopted amendments to its regulations regarding the conversion proxy solicitation process. Second, the Board adopted amendments to clarify and simplify the rules and make modified conversions more attractive. In 1985, the Board also proposed amendments to regulations governing voluntary supervisory conversions and modified conversions of mutual insured institutions to stock form. The purpose of the proposed amendments is to clarify several of the policies and interpretations of the Board and to expedite the processing of voluntary supervisory conversion and modified conversion applications.

In addition, staff is now actively examining additional, far-reaching measures that would further streamline the conversion process and, therefore, further enhance the use of conversions. The Board recognizes conversions are a unique capital raising tool, and staff is developing recommendations directed, in particular, at facilitating investment of new capital in ailing institutions through the supervisory and modified conversion processes.

V. OTHER BANK BOARD LEGISLATIVE PROPOSALS

The Bank Board strongly believes that various components of its legislation, which have been before Congress for over two years now, are critical to instill equilibrium to the thrift regulatory structure and reaffirm its historic Congressionally mandated mission of providing economical home financing.

1. EXPANDED ENFORCEMENT POWERS

The severe financial crisis which has plagued the thrift industry over the past several years has painfully heightened the Bank Board's awareness of the need to improve and enhance the authority of the Board to examine and supervise the institutions under its jurisdiction. During this time, we have had to allocate our limited resources to handle only the most critical situations rather than systematically pursuing a thorough program of examination and supervision aimed at preserving the health of institutions that are still viable. But still hampering our efforts to provide adequate and timely supervision are outmoded and time consuming enforcement authorities which do not reflect, and can not respond quickly enough to, the volatile and fast-changing financial environment in which thrifts compete. For these reasons the Board will be requesting a number of legislative changes to strengthen the enforcement tools it uses to monitor risk-taking and avert substantial losses to the FSLIC fund.

The requested changes to our enforcement authority may be divided into three general areas. The first area for legislative action includes our proposed amendments to strengthen the Board's authority to issue temporary cease-and-desist orders. At the present time, a temporary order that is immediately effective may be issued only when an alleged violation or unsound practice is likely to cause insolvency, a substantial dissipation of assets or earnings, or a serious weakening of the financial condition of the institution. Because our statute allows an institution or individual served with such an order to challenge the temporary order within ten days in

U.S. District Court, the Bank Board cannot simply state that the violation is one that may produce serious losses. Instead, it must stand ready to prove those losses in court at the time it serves the temporary order on the institution. The result is a loss of valuable time while the Board gathers proof of insolvency or substantial losses, even though we know through facts gleaned from our examination process that a serious problem exists at an institution. To correct this situation an amendment is needed to remove the modifiers of "substantial" and "serious" before the findings of "dissipation" or "weakness" in such emergency cases.

Another integral part of the needed improvements to our cease-and-desist authority is the addition of a new provision which would enable the Board to issue a temporary order to halt an institution's making of new loans or investments whenever we are unable to determine the true financial condition of an institution, despite the efforts of our examiners, because of the disarray in, or lack of, books and records. Deficient recordkeeping has been a recurring theme in the more serious thrift failures over the last two years and exacerbates the difficulties encountered in resolving insolvent institutions. The poor quality of, and often lack of, books and records in such cases is the unfortunate by-product of the cycle of excessively rapid growth of savings deposits and the rush to place those deposits into potentially high-yielding, but also high-risk loans. Such an addition would empower the Board to halt any new lending by an institution until the institution's books and records are in an acceptable condition -- sufficiently in order for our examiners to determine the financial condition of the institution.

We also advocate several other changes to the existing cease-and-desist authority to close loopholes and clarify the present statutory language. These amendments include stating clearly that the agency may bring enforcement actions against second-tier and partly-owned subsidiaries of insured institutions, including those that are wholly-owned by several thrifts. The amendments would also clarify that the Board has the power, at the conclusion of cease-and-desist proceedings, to order affirmative corrective actions such as restitution, rescission, the disposal of loans, and guarantees against loss, to correct the conditions caused by unsafe and unsound practices and violations of regulatory requirements.

Another key area for legislative improvement is the Board's removal and prohibition powers. It is unfortunate, but in many cases true, that it is more difficult to meet the statutory grounds for removing a banker or thrift official from office than meeting the grounds required to convict him of a criminal offense. Because we respect the constitutional right of each citizen to due process of law, we are requesting only modest changes to the removal statute in our proposed legislation despite our strong desire to act quickly to remove negligent or wrongdoing thrift officials. These changes include: (1) a clarification of who may be removed and/or prohibited as well as when the action may be brought, to avoid claims that the agency loses jurisdiction when a person resigns before a removal action is complete; (2) a removal of the modifier "substantial" before a finding of financial loss to an institution is the second ground required for maintaining a removal case; (3) a recognition that harm to shareholders of a stock institution as well as to members of a mutual association should be considered in removal cases; and (4) a change that makes the grounds for removal of an official from a second institution for misconduct at another institution the same as the grounds for a direct removal from the first institution.

In addition, we need legislation which would continue and broaden the industry ban that presently exists for individuals who have been removed. Currently, a thrift official removed from one FSLIC-insured institution may not serve as a director, officer, or employee of another FSLIC-insured institution, although he or she may work for an FDIC-insured bank or a NCUA-insured credit union without penalty. We propose an expansion of the existing ban not only to prohibit a removed individual from working in FSLIC-insured institutions, but also to prohibit an individual removed by an agency from employment in any type of insured financial institution without the prior approval of the appropriate regulatory agency.

The third key element to the legislative strengthening of the Board's enforcement authority is an amendment clarifying the reach of the Board's enforcement powers by specifying in new definitions the institutions and individuals who may be subject to administrative enforcement proceedings. We will ask for specific legislative authority to define by regulation an unsafe or unsound practice so that we can move much more quickly against poorly run, imprudently operated institutions and prevent, earlier on, expensive losses to the FSLIC fund.

The adoption of these necessary changes will provide the Board with the needed flexibility and tools required to deal with an increasingly complex industry and its problems before the problems become very costly disasters for the FSLIC fund.

2. POWERS OF STATE-CHARTERED THRIFTS

As the head of the FSLIC, the Bank Board is dedicated to assuring sound operating procedures and investments by thrifts within the housing specialization Congress created and mandated for the industry. The FSLIC is faced with the task of underwriting risks and investments which Congress never contemplated when it created the thrift regulatory structure, largely as a result of vastly liberalized state empowerments for thrifts. Some state legislatures have gone well beyond the confines of those activities Congress found suitable for federal deposit insurance as recently as the additional powers granted in the Garn-St Germain Act of 1982. These states have enabled their own state-chartered savings institutions to go into all manner of "entrepreneurial" endeavers, irrespective of the risk of loss to the financial underwriter of such activities. Yet these same state legislatures require their entrepreneurial empowered state-chartered thrifts to be federally insured. These same states never are called upon to pay a penny of loss when even one of their state-chartered thrifts fail. Thus, any risk of loss is effectively transferred from their own treasuries to the FSLIC. At a time when the resources of the FSLIC are under tremendous strain, and when more states appear to be moving toward additional state thrift powers, we believe it is important that any deposit insurance reform enable the insurer to better underwrite the risk of loss to the reserves of the deposit insurance fund.

The Bank Board does not quarrel with the prerogatives of states to establish the nature and extent of activities which their own state-chartered institutions may be permitted to engage in. We do believe, however, that the federal deposit insurance system for thrifts -- namely the FSLIC -- should be able to determine the manner in which such activities are underwritten for risk of loss to the fund. To achieve a balance between the two competing interests, I believe Treasury Under Secretary Gould's recent suggestion -- that those state-chartered thrift activities which go beyond what Congress has authorized for federally-chartered institutions be allowed only in holding company subsidiaries -- is a particularly interesting one and deserves consideration by the Congress. Under Mr. Gould's proposal, rather than restricting the activities of some state-chartered thrifts whose powers greatly exceed those of federally-chartered institutions, these institutions would be authorized to engage in these "extra-federal" activities. His quid pro quo for the prerogative of doing so is simple: do it in a subsidiary of a holding company. This would very significantly insulate the FSLIC from any risk of loss deriving from activities or asset baskets not specifically authorized for thrifts by the Congress.

In my own view, Under Secretary Gould is suggesting a variation on the conceptual idea the Bank Board has addressed in its risk premium approach.

The Bank Board's risk premium scheme would underwrite the risk of loss by pricing it accordingly, and would reduce risk premiums in inverse proportion to an institution's net worth.

In my own opinion, each of these approaches has merit, though some will disagree.

The risk-based capital approach being offered by some differs in that basically the higher the capital of an institution, the more activities that institution may engage in. Stated another way, the higher the capital to cover losses, the greater the ability to engage in riskier types of activities. Each of these approaches constitutes a form of insurance risk underwriting.

We find the risk-based capital approach to underwriting risk to have considerable merit also, and we do not find it mutually exclusive of the risk premium approach, especially in the case of activities which extend beyond, and in some cases well beyond, what Congress found suitable for federal thrifts.

Mr. Gould's proposal, in my own view, would further encourage institutions in mutual form to convert to stock form. This, too, would have the advantage of bringing in new capital to converting mutuals. This is consistent with the Board's actions to encourage greater capital in the industry.

I believe capital must be restored to improve the long-term health of the industry. In connection with this goal, the Board supports two legislative amendments as additional incentives to federally-chartered institutions to increase their net worth levels. First, I believe that federally-chartered thrift institutions which meet or exceed a net worth level to be determined by the Bank Board (such as five or six percent) should be able to invest 5 percent of their assets in service corporations. Second, I believe that Congress should clarify and affirm the Board's authority to determine the appropriate activities of federal service corporations by regulation, including the ability to closely correlate the types of service corporation activities with certain net worth levels to be maintained by the insured parent. Our ability to provide for pre-approved service corporation activities since the Garn-St Germain Act of 1982 has been constrained by the legislative shadow of the conference statement that the Bank Board "should not approve, in the absence of clear and specific Congressional authorization, any new regulation expanding activities of service corporations other than to permit service corporations to engage in activities permitted for federal thrift institutions."

3. VALIDATING THRIFTS' UNIQUE MISSION

After long and careful deliberation, the Task Group on Regulation of Financial Services headed by Vice President George Bush unanimously agreed that savings institutions are indeed different from commercial banks, and that a separate thrift industry is a vital force in the nation's housing finance system. The Task Group recommended that "a portfolio test should be established to determine whether an institution is, in fact, essentially engaged in traditional specialized thrift activities."

Thrift institutions have been the single most important private sector force for making America a nation of homeowners throughout the years. Helping them to renew their strength so that they can continue to serve the housing finance and related needs of American families, while at the same time building on the time-honored concepts of safety and soundness, are the fundamental goals of this Bank Board. To this end, establishing an asset composition test will provide the most equitable and realistic means of preserving the specialized functions of thrifts by distinguishing such institutions and extending to them unique regulatory benefits based on their commitment to housing finance and other housing-related investments.

The Bank Board continues to urge adoption of an asset composition test which serves as a benchmark for thrift eligibility for ownership by diversified companies, access to Federal Home Loan Bank System advances, and access by state-chartered thrifts to FSLIC deposit insurance. I believe such a test is a critical supplement to our suggested reforms to thrift deposit insurance because it reflects the reality of the distinctive marketplace functions of thrifts and banks. Such a test also provides an additional fair and practical means to assure that only those institutions with a substantial commitment to housing finance will continue to function within a framework specifically fashioned by law to aid their mission.

Every thrift should be able to pursue diversification options. But if diversification involves discarding home finance as the principal mission, an institution should not be allowed to compromise the purpose of the separate thrift regulatory structure by freely availing itself of that structure's special benefits. An appropriate asset test would resolve this problem by denying future bank-like thrifts the benefits which should be preserved exclusively for institutions dedicated principally to housing finance and housing-related investments.

At the same time, such a test would reaffirm the intent of the Garn-St Germain Act "to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and insuring the availability of mortgage loans."

I believe the asset composition test included in the Board's legislative package will insure a significant and continuing emphasis on home finance by those lenders which seek the benefits of the unique home finance regulatory framework. Under the test, a "qualified thrift lender" would have to maintain at least 60 percent of its assets in specific housing and housing-related investments and certain liquid assets. An institution which failed to maintain that status would be ineligible to regain it for a period of five years. Mutual savings banks would be allowed a 20 year period to phase up to the 60 percent investment requirement.

While the current "thriftness" test established by Section 7701 of the Internal Revenue Code and used to establish eligibility for unitary ownership by the Garn-St Germain Act serves as the guidepost for the test in our legislation, our new test would also include certain new qualifying assets we believe vital to allow flexibility to thrift managements to develop their own housing focus. These would include liquid assets qualified under Section 5A of the Federal Home Loan Bank Act, loans, equity positions or securities related to residential real estate, investments in mortgage-related securities, and investment in all shelter providing facilities such as nursing homes and student dormitories. Because our legislation would afford the FSLIC broad authority to interpret and regulate regarding the qualifying asset test, the Bank Board could address any potential misuse of this "laundry list" -- such as excessive concentration in liquidity items -- by imposing limits on particular types of investments.

We are firmly convinced that the liquid assets included in this definition are a crucial component of any thriftness test. Maximum flexibility in this regard is absolutely vital to allow a thrift to manage liquidity effectively in volatile economic conditions, and make investments closely related to its home financing function. The

Federal Home Loan Bank Act already requires its members to hold such liquid investments at a level between four percent and ten percent as determined by Bank Board regulations.

Our proposal also authorizes the Bank Board to accord some level of credit to thrifts which support housing through originating loans and selling them in the secondary market, while generating servicing fee income. The proposal authorizes the Bank Board discretion in setting an appropriate level of credit. Thrifts which have a substantial portfolio investment in home loans as well as significant secondary market activity should not be arbitrarily deprived of qualified status. This flexibility will also aid managers to cope more effectively with changing economic conditions which may dictate higher levels of secondary market activity as a means of offsetting loans arising from maturity mismatches which are a continuing threat to the thrift industry.

The Board's proposal provides a qualifying averaging period of three out of five years. We believe that this longer qualifying averaging concept is appropriate given the vagaries of housing demand and the sensitivity of the industry to rate swings. The three out of five year concept is also a crucial supplement to the liquidity and secondary market provisions of our legislation and would further aid institutions in dealing with volatile conditions in a rapidly changing marketplace without the penalty of disruptive changes to holding company activities or constraint on access to Federal Home Loan Bank advances.

4. TANDEM OPERATIONS

The Bank Board continues to have serious concerns that the current "in tandem" language of H.R. 20, if enacted, could seriously prejudice the thrift industry's ability to remain viable competitors in the financial services arena. We are concerned that this provision could cripple the benefits of capital development and diversification long provided thrifts through affiliation with unitary savings and loan holding companies.

The "in tandem" provision we will include in our legislative package is intended to alleviate our concerns about the role and risk to the FSLIC fund posed by non-financial firms effectively usurping federal insurance for all manner of retail and investment products, while at the same time preserving certain "in tandem" operations if the affiliate engages only in activities permissible within a multiple holding company. Moreover, a unitary holding company-owned thrift and its affiliates would continue to have the ability to cross-sell credit or managerial services in a variety of situations where such marketing is an efficient means of increasing financial strength and profits related to traditional thrift activities throughout the holding company structure.

This provision would allow the Bank Board to deal with adverse effects arising from the cross-selling by a savings and loan holding company and its affiliates of their goods and services on a specific case-by-case basis. Those activities which the Board determines cause adverse effects such as conflicts of interest or unsound practices would be prohibited.

5. RECEIVERSHIPS

Our legislative package provides increased clarity regarding the FSLIC's authority for appointment of a receiver for failed institutions based on an express statutory authority to further define "unsafe and unsound condition to transact business" and "substantial dissipation of assets". These provisions would also establish priorities of unsecured creditors against a receivership estate, and would permit the FSLIC to receive reimbursement for amounts paid to insured depositors before uninsured depositors are paid.

VI. CONCLUSION

I look forward to working closely with the members of this Subcommittee to revitalize the financial resources of the FSLIC and assist thrift industry's continued progress. Your continued support and confidence is critical to the process. A great many actions must be taken -- and taken soon -- to strengthen national thrift system.

I will be pleased to answer any questions you may have.

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

JAN 27 1986

Mr. Craig Simmons
Associate Director
U.S. General Accounting Office
Room 3858A
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Simmons:

After carefully reviewing the GAO report entitled "Thrift Industry Problems--Potential Demands on the FSLIC Insurance Fund," I am concerned that the report, perhaps inadvertently, overstates the problems facing the FSLIC. Specifically, on page 4, the report states that the financial condition of nearly 1300 FSLIC insured institutions is weak. To imply that over 42 percent of the industry is likely to require some form of FSLIC assistance seriously distorts the magnitude of the problem. I fear that if such an overstatement were to become public it could seriously worsen the actual situation.

The report's tendency to overstate the size of the problem partially results from its lack of a clear definition of what constitutes a problem institution. While this is a difficult task, such a characterization must be specified before the number of potential problem cases can be estimated. From our own perspective, there are at least three variables that should be weighed before an institution is considered a potential problem case. The level of net worth is clearly an important factor. The report devotes substantial effort to justify its focus on the GAAP measure of net worth. The primary distinction between RAP net worth and GAAP net worth is that the former allows for a gradual amortization of losses while the latter requires an immediate reduction in earnings, and thus net worth, for assets sold at a loss. RAP accounting removed the accounting deterrent inherent in GAAP to portfolio restructuring. Thus, by encouraging thrifts to remove underwater assets from their books, RAP accounting has allowed many thrifts to restructure their portfolios and significantly improve their long term viability. Therefore, while the current level of net worth is important, an equally important factor is a firm's future earning potential. This potential can be approximated by the firm's current reported earnings and its latest supervisory rating. The supervisory rating provides an indication of the underlying quality of the firm's assets and management. Note these variables only indicate potential problem cases and do not imply that an institution will necessarily require FSLIC assistance.

On page 4, the report states that if GAAP-insolvent thrift institutions were recovering, the level of concern over the condition of the industry and its implications for FSLIC would not be high. The report proceeds, however, to ignore this statement and to analyze the potential cost to the FSLIC from liquidating or merging all GAAP-insolvent institutions. Thus, in Tables 3 and 4, on pages 16 and 17, the GAO report provides figures on the number of insolvent and low-net-worth institutions. Then, on page 5 and in Table 5 on page 18, the report estimates the potential losses for the FSLIC from liquidating or merging these insolvent institutions to be between 5 and 23 billion dollars. To suggest that all GAAP-insolvent institutions will require FSLIC assistance is simply inappropriate. As I have already indicated, such an approach ignores future earning potential and thus tends to dramatically overstate the size of the problem.

A more reasonable approach is the one used in Table 6. This table identifies the number of insolvent and unprofitable institutions, then estimates the potential cost of resolving only these cases. Contrary to statements on page 1 of the report, only half of the insolvent thrifts were unprofitable during the first half of 1985. Table 6 identifies 239 GAAP-insolvent institutions that were unprofitable for the first half of 1985. These institutions, representing less than 8 percent of the industry, could be considered weak and potential problem cases for the FSLIC. This number is significantly less than the 1,300 institutions with assets of $433 billion, or 42 percent of industry assets reported in the GAO document. Thus, while the numbers used in the other tables are accurate, I feel they substantially misrepresent the current situation. Furthermore, since these figures are thoroughly discussed before those in Table 6, I believe they overshadow this more reasonable approach.

While the GAO report explains on page 2 why it does not examine the resources available to the FSLIC, such an omission inherently raises doubts as to the adequacy of FSLIC resources. By simply suggesting possible resolution costs, the report ignores the potential for future revenues and the ability of the FSLIC to find no-cost resolutions to many of the cases. For example, some of the cases may be resolved through voluntary or non-assisted mergers and therefore cost very little to the FSLIC. This approach is projected to reach close to 100 institutions over the next year, further reducing the number of potential institutions that may require FSLIC assistance to under 200 firms.

The report also does not acknowledge that numerous techniques exist for replacing the current managers of weak institutions and thereby limiting any growth of the problem. The MCP program, for example, provides a mechanism to assist insolvent and unprofitable thrifts in an effort to reduce further deterioration. Once the growth of the problem has been stopped, various techniques are available to defer the need for FSLIC to make immediate cash outlays. This postponement allows the FSLIC time to accumulate substantial resources from premium income and investment income. Premium income is projected to be approximately $1.89 billion in 1986 and $2.08 billion in 1987 if the special assessment of one-eighth of 1% is continued. Investment income should generate almost one-half billion dollars a year.

The report further fails to include the significant lines of credit available to the FSLIC. The FSLIC may borrow from any of the twelve Federal Home Loan Banks, limited by the financial capacity of the Banks and the willingness of each of their Boards of Directors to authorize funds to FSLIC.

The Federal Home Loan Banks have assets of over $100 billion and are capitalized at close to 9 percent. Furthermore, the Bank's assets are substantially over collateralized. This strength allows them to borrow money at rates slightly above Treasury rates. To date, the FSLIC has borrowed $900 million from the FHLB's which has been passed through FSLIC in collateralized loans from which the FSLIC expects to experience no financial losses. Given a prudent expansion of the Banks' capital base, over an extended period of time, five years for example, this device could provide the FSLIC with up to five billion dollars. FSLIC also has a direct line of credit from the U.S. Treasury in the amount of $750 million. This line was established by legislation in June 1950 and has never been used.

The report's analysis on page 6 and in Table 9 of the effect of a 1 percent assessment is especially distorted. The report states "FSLIC and the Bank Board have the power to levy a supplemental insurance assessment on their constituent institutions equal to 1 percent of deposits... Such an assessment would increase fund reserves by roughly $8 billion." The FSLIC may "assess" an amount equal to one-eighth of one percent of accounts in any single year to meet losses of the FSLIC. The statutory provision for a call equal to one percent of accounts, however, provides for a deposit which would be a debt of the corporation. This call would improve the FSLIC's liquidity, but would not affect its net balance sheet position. Thus, the reserve or equity position of the FSLIC would not be increased by $8 billion or by any amount under the Bank Board's statutory authority to make a call equal to one percent of accounts. Also, institutions would not become insolvent as a result of the call since they would now have a FSLIC asset on their books. Their net position would be unchanged. If the report is suggesting a levy comparable to NCUA powers, it is important to note that the Bank Board does not have such powers.

In summary, while the raw data base for this report is accurate, its utilization distorts the magnitude of the problem facing the FSLIC. It also seems inappropriate to suggest a dollar cost of resolution without exploring the specific method of resolution. Furthermore, to examine only the cost of resolution without examining the sources of revenue ignores a vital aspect of the overall nature of the problem. Finally, it also should be mentioned that the industry has had two very profitable quarters not included in this report, and that the industry on a market value basis recently turned positive for the first time in a number of years.

I trust you share my concern that the magnitude of the problem facing the FSLIC not be, perhaps inadvertently, overstated. Such an overstatement could only serve to worsen the actual situation. I believe that an accurate portrayal of this problem is necessary for the Congress to formulate as it may choose any legislative response.

Sincerely,

Edwin J. Gray

Appendix B

Title II of the Garn-St Germain Act provides the thrift industry with assistance in managing their financial problems while the industry is restructuring. The Act established a three-year program whereby the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Corporation (FSLIC) may purchase "net worth certificates" from troubled depository institutions in exchange for promissory notes according to a prescribed formula that covers a partial portion of losses. The certificates are considered capital, and for that reason would increase the net worth of the affected institutions. This assistance does not require cash outlays, however, unless an institution defaults. This program is intended to provide thrift institutions that are otherwise well managed with a way to improve their net worth positions until the temporary losses caused by inflation, high interest rates, and over-regulation can be brought under control.

Figures contained in Appendix IV of the 7/3/85 GAO report, titled "Federal Banking Agencies are Adequately Examining Net Worth Certificate Program Applications," showed that the aggregate regulatory net worth and the aggregate regulatory net worth without net worth certificate assistance of 51 FSLIC-insured institutions with net worth certificate assistance outstanding as of June 30, 1984, and which had participated in the Bank Board's net worth certificate program since its inception in December 1982, had decreased by 8.8% and 23.2%, respectively.

As of June 30, 1985, four of the 51 institutions included in the GAO study had merged into other institutions, and two institutions had been acquired by other institutions subsequent to June 1984 but prior to June 1985. As shown by Table 1 to this Appendix, the aggregate regulatory net worth of the 45 institutions remaining had increased 19.0% from June 1984 to June 1985 and 8.5% from December 1982 to June 1985, while their aggregate regulatory net worth without net worth certificate assistance had increased 19.8% from June 1984 to June 1985 but had decreased 8.1% from December 1982 to June 1985. Table 2 to this Appendix shows the recent positive effects of net worth certificate assistance on the net worth and net operating income of four participating institutions.

The original intent of the net worth certificate program was to give institutions time to restructure their balance sheets to lessen the asset/liability mismatch. The improvement in the regulatory net worth position, with and without net worth certificate assistance, from June 1984 to June 1985, of the remaining institutions included in the GAO study indicates that the program has not failed but is, in fact, working as intended. Therefore, we believe that this evidence supports our contention that the program should be extended so that institutions operating in the currently favorable interest rate environment can be given additional time to restructure their balance sheets.

In administering the net worth certificate program, the Bank Board has sought to minimize potential exposure of the FSLIC fund. As a result of this and lower interest rates, not all eligible institutions have applied for the program. Should interest rates rise in the future, however, the net worth certificate program would be a valuable emergency tool both in terms of delaying eventual failures and allowing time for restructuring to alleviate pressures on the fund to provide cash assistance. The Board thus strongly urges Congress to extend the net worth certificate program.

Table 1

Regulatory Net Worth for FSLIC-Insured NWC Institutions
for December 1982, June 1984, and June 1985

	December 1982 ($ mil.)	June 1984 ($ mil.)	June 1985 ($ mil.)	$ change Dec. 1982 to June 1985	$ change June 1984 to June 1985
Regulatory net worth NWC institutions	260	237	282	8.5	19.0
Regulatory net worth without NWC assistance NWC institutions	211	162	194	-8.1	19.8

Sources: December 1982 and June 1984 figures are from Appendix IV of 7/3/85 Report (GAO-GGD-85-33) and include 51 institutions identified by GAO/GGD. June 1985 figures are from the FHLBB Quarterly Report System and include 45 institutions (51 above, minus 4 merged into other institutions and 2 acquired by other institutions subsequent to June 1984 and prior to June 1985).

Table 2

POSITIVE EFFECTS OF NET WORTH CERTIFICATE ASSISTANCE
(As of 12/31/85; dollars in millions)

Institution	Total Assets	Amount of Net Worth Certificates	Regulatory Net Worth As a percent of Assets 3/31/85	12/31/85	% Improvement	Net Operating Income 3/31/85	12/31/85	$ Improvement
Milford FS&LA Milford,MA	$142	$0.150	2.60%	3.77%	1.17%	$0.385	$0.798	$0.413
State Savings,FA Jackson Heights, NY	$312	$0.425	3.36%	3.99%	0.63%	$1,326	$1,952	$0.626
Columbia FSB Woodhaven, NY	$951	$0.250	3.60%	5.04%	1.44%	$0.926	$3,757	$2,831
First FS&LA Missoula, MT	$ 64	$0.100	2.49%	2.83%	0.34%	$0.031	$0.123	$0.092

Appendix C

MUTUAL-TO-STOCK CONVERSIONS
1972 - 1985

Year	FILED Yearly	Cumul Total	APPROVED Yearly	Cumul Total	COMPLETED Number	Amount of Stock Sold (in millions)
1972-1974	31	31	0	0		
1975	6	37	6	6	1	1.3
1976	29	66	15	21	14	50.9
1977	25	91	10	31	14	29.6
1978	21	112	4	35	5	13.5
1979	42	154	17	52	15	114.4
1980	51	205	46	98	16	141.4
1981	57	262	39	137	37	126.6
1982	35	297	34	171	31	123.0
1983	115	412	108	279	83	2,734.0
1984	88	500	100	379	95	711.0
1985	52	507*	61	404**	76	1,384.0
			TOTAL		387	5,438.0

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* Adjusted for applications removed from the program.

** Thirty-six conversions were discontinued and the stock was not sold.

Appendix D

FSLIC Insured Institutions

	September 30, 1985				January 31, 1986	
	NUMBER			ASSETS (In Billions)	NUMBER	ASSETS (Billions)
	Fed'l	State	Total			
MUTUAL	1355	819	2174 (67%)	$ 464 (45%)	2150 (66%)	469 (44%)
STOCK	355	693	1048 (33%)	577 (55%)	1098 (34%)	601 (56%)
TOTAL	1710	1512	3222 (100%)	$ 1,041 (100%)	3,248 (100%)	1,070 (100%)

As you can see from this table, the assets of the stock institutions continue to increase at a rate disproportionate to the ratio of stock institutions to mutual institutions.

APPENDIX E

Specific Questions Posed by the Committee on Banking, Housing and Urban Affairs of the United States Senate

1. Assessing Industry Soundness

The first of four questions the Committee posed requests the Bank Board to set forth those steps the Bank Board could take to improve its capability to assess the financial condition of institutions, and to assess end predict the likelihood of an institution's failure.

The Board has taken a number of steps to improve its ability to assess the condition of the institutions which it supervises and regulates. The Bank Board has focused major attention on modernizing the examination process. One example is the introduction of a new Quarterly financial reporting system and implementation of a sophisticated series of reports for use by examiners and supervisors in analyzing these data.

A particular benefit of the new Quarterly reporting system, which replaced a Semi-annual reporting system, is more timely reporting of data by institutions. As part of a monitoring process which takes place continuously in our field offices, examiners review a series of "triggers and flags" which highlight associations with abnormal or substandard conditions as reflected by certain key ratios. These indicators are available from the computer soon after an institution submits its report.

Complementing the Quarterly data system is a Monthly reporting system for all insured institutions which provides even more timely early warning of trends in association conditions, although at a less detailed level. The Bank Board is currently revising its Monthly report to double the amount of information included in the report on key conditions such as changes of control. The latest revisions in the Monthly report are a part of the Board's efforts to maintain an up-to-the-minute, state-of-the-art tool for the collection of key financial data. This combination of Quarterly and Monthly data, new output reporting systems, and procedures for continuous monitoring of these reports in all of the examination offices will provide the Bank Board with timely early warning of certain conditions warranting more in-depth on-site examiner review.

The Bank Board is also in the process of developing other tools to enhance its ability to effectively monitor, supervise and examine thrifts. The first of these new tools is the revision and expansion of the examination tracking system. These revisions will allow examiners, FHLBank supervisory personnel and Bank Board staff to access via computer existing and newly developed examination data. The data to be made available will include summaries of examination findings, factor ratings for each examination, and selected statistical data. Full implementation of the expansion of the examination tracking system is estimated to take approximately one year.

The second new tool the Board is currently developing is the implementation of a supervisory action control system. The purposes of this system are to provide information on the status of supervisory actions, resolution of problems by supervisory action, the supervisory history of a particular thrift, and aggregate data on the number, types and status of supervisory actions. It is anticipated that full implementation of this computer information system will take approximately one year, although manual compilation of the data will begin sooner.

The third improvement the Bank Board is undertaking is an improvement of the examination reports and expansion of their scope. This includes efforts to provide microcomputers as part of the examination process. It is the Bank Board's goal eventually to enable its examiners to complete and transmit the examination reports by computer. This will considerably speed the completion of examination reports and enhance the examination process.

We realize that financial reports from the industry cannot provide us with all of the information we need for timely warning of supervisory problems. No computer can take the place of an examiner on-site at the institution in identifying and analyzing poor loans and other asset quality problems. In those areas requiring an on-site examiner presence, the timely discovery of problem conditions requires simply that examinations be performed more frequently, and that when conducted the scope of examination be wide-ranging. The scheduling of on-site examinations may now be made more frequently due to our expanding field staff and the data "flags" which more readily highlight the need for examination.

Although prompt scheduling of examinations is crucial, it is equally crucial that the results of that examination be forwarded to Bank Board supervisory staff quickly. In this area the Bank Board continues to emphasize to its examiners the importance of interim reporting to supervisory staff to trigger quick action. The consolidation of our examination staff and Bank supervisory staff within each of the Federal Home Loan Banks is allowing us to address the critical manpower shortage and high turnover that had existed in our examiner ranks. In addition, it also serves to improve the coordination and timely communication between our examination and supervision staffs.

In modernizing the examination process, we also have been investigating new tools and techniques for assessing the condition of financial institutions. As already mentioned, the new computer-generated reports are now available quarterly. A significant feature of these reports has been the emphasis on 'gap management'. Previously, the semi-annual reporting system generated four pages of reports regarding each institution. The new quarterly system generates four pages of reports solely on an institution's 'gap'. Schedule H -- the input schedule which the association submits -- and the output 'gap' report which goes back to the institution, does a significant job in helping our examiners and the industry analyze and understand clearly the risks presented by a mismatch of yield and maturity between an institution's interest-bearing assets and interest-bearing liabilities.

Another step which we have taken internally to provide additional sources of information to the field is to send the Form 10Qs, 10Ks and other Securities Act filings received at the Board to our field staff as they are received in Washington headquarters. The Bank Board has jurisdiction to administer certain of the securities provisions of the Securities Exchange Act of 1934 with respect to institutions chartered by the Board or insured by the FSLIC. As a result, the Bank Board receives and reviews Exchange Act filings and has in the past coordinated that review when necessary with field staff on questions of accuracy. Supervisory staff in the field will often contact Washington securities staff to report a material development concerning an institution. The Board believes that it is necessary for all of the information which comes to the Board from '34 Act filings to be shared with the field as well.

With the new information sources, a more prompt examination schedule and more complete examination scope, our staff will have the information to assess the condition of financial institutions. The new 'gap' reports have given our staff the ability to predict failures that arise from interest-rate risk. With more examiners in the field, our ability to detect poor quality of assets and predict failures because of credit risk will rise as well. The Bank Board staff also have developed a number of computer-based calculations which predict failures. Some of these are quite sophisticated, some of them are less so. They are all useful to a certain degree. However, given the very subjective elements inherent in balancing the many factors indicative of soundness or serious problems the Board has always relied on its field examination staff for the final determination of a potential failure.

Ability to Predict Failure

Savings and loan associations experiencing severe financial problems, which will likely involve assistance from the FSLIC, usually involve two types of problems: negative yield spreads or poor quality assets.

As stated in the main body of our testimony, prior to 1983, the industry's assets consisted of residential mortgages, and liabilities consisted of savings accounts, mostly under rate control, and Federal Home Loan Bank borrowings. During this time, most problem cases were

The CHAIRMAN. Thank you, Mr. Gray.

Mr. Seidman.

STATEMENT OF WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you, Mr. Chairman, Senator Proxmire, Senator Hecht. It's a pleasure to be before this committee to discuss deposit insurance reform and bank supervision.

I have a full statement which I ask be entered into the record.

The CHAIRMAN. It will be included in full in the record.

Mr. SEIDMAN. Thank you, sir.

You, Mr. Chairman, have held a number of very valuable hearings and a great many educated views on these subjects have been expressed. We have considered these views and our own experience, especially our recent experience, in coming to our conclusions.

URGENT NEED FOR SELECTIVE CHANGES

We at the FDIC have concluded that there is an urgent need for selective changes in the Federal Deposit Insurance System. In my testimony, I will indicate where I believe changes are necessary. These changes will include those requiring Federal legislation and those requiring State legislation, and those that could be implemented by the FDIC under existing law.

As you know, last year, there were 120 bank failures and FDIC assisted mergers. Likely, we will see at least that many this year.

Bank failures have increased primarily because of the weakness in the economy, particularly in selected sectors and regions.

Weakness in energy and agriculture and in several foreign countries that are substantial borrowers from U.S. banks are likely to persist for a while. And the banking system will continue to be affected by these strains.

Interest rate deregulation, easier market entry by depository institutions, nonbank competitors, and foreign banks have all contributed to competition. This has put pressure on earnings and contributed to increased risk-taking by some banks and, undoubtedly, also contributed to a recent higher failure rate.

More than 95 percent of deposits and other general creditor obligations to failing banks have been fully covered as a result of purchase and assumption transactions, and assisted mergers arranged by the FDIC.

This has caused some to argue that the level of comfort provided by deposit insurance has been too high, and an important contributor to the failure problem.

While it is difficult to precisely assess the accuracy of this proposition there is no evidence that deposit insurance has importantly contributed to bank failures. Deposit insurance has worked well by protecting depositors, maintaining confidence in the banking system, and limiting adverse secondary effects of bank failures.

The increase in failures, however, has exposed the need for change in the Federal Deposit Insurance System and the manner in which bank failures are handled.

due to negative or poor yield spreads, caused by rising short-term interest rates. Monthly operating losses could be monitored from monthly reports; such losses would remain relatively constant, and would generally rise and fall with changes in short-term interest rates. In 1981, OES developed a computer based insolvency report, based on the monthly reports submitted by all associations. The report averaged the monthly operating loss for the three most recent months, and divided the average loss into current net worth. Associations with less than 24 months to insolvency were printed on a computerized report. The computerized report was put into a monthly written report, which is still used as a monitoring device and management report by OES. Despite its simplicity, the insolvency report has been remarkably accurate in predicting failure in those associations with spread problems.

The other major problem facing the industry -- poor quality assets -- poses a much greater difficulty in predicting failure. The nature of asset problems is that, once a bad loan or investment is made, very little can be done to prevent a loss; if enough bad loans and investments are made, little can be done to prevent the association's failure. With construction loans, industry practice is to pay interest out of loans-in-process during the construction period, with repayment dependent on the successful and timely marketing of the project. Clear evidence of a project's failure is usually not evident until the project is completed and not sold, usually eighteen months to two years after the granting of the loan. Typically, during an examination or audit, reappraisals are ordered or net realizable value calculations are made. Significant indicated losses will result in the request for loss reserves, which may immediately deplete the association's net worth, which may have appeared adequate before the write-downs.

There are several indications of asset quality problems. The first is a change of business plans in which management enters a new area in which it has little expertise. Adverse comment in examination reports on underwriting, credit analysis, lack of feasibility studies, appraisal practices, and loan procedures, is an indication of problems. Due to the length of a project, it is possible for markets to change, rendering a once viable project a problem. Eventually, asset problems will be reflected on an association's earnings statement and statement of condition. A significant volume of non-earning assets will result in declining net income and losses. Increasing amounts of Real Estate Owned and delinquent loans will be reflected on monthly reports. Increasing uncollected interest also indicates a materializing problem. However, all of these indications pertain to bad loans and investments which are already on the books. The loss or failure is not really being predicted - it already exists, but may not be recognized or booked.

Given this inherent problem with predicting asset quality failures, the Bank Board believes our best hope for more efficiency in this regard is to obtain the new statutory enforcement powers

detailed in our statement. While the new authorities will not avert failures in most cases, they can help us to act quickly on the warning signals of potentially serious problems provided through our routine monitoring and examinations, and thereby reduce the volume of losses to the institutions and to the FSLIC.

Improvements in the Quantity and Quality of Personnel

As explained in the main body of our testimony, the field examination function of the Bank Board was transferred to the twelve Federal Home Loan Bank districts on July 7 of last year. This significant move has enabled us to build a better trained and more effective field examination force. By the end of 1986, we expect to increase the number of field examiners from 747 to more than 1,500.

Assessment of Risk

The second question posed by the Committee requested that the Bank Board address the appropriate criteria for differentiating between institutions in several areas including risk-based capital requirements and risk-based deposit insurance. Both of these areas are discussed in the main body of our testimony.

A question related to the application of risk-based capital requirements is the application of capital standards to off-balance sheet liabilities. The Bank Board's existing net worth regulations require the maintenance of capital equal to 2 percent of recourse liabilities. In addition, the Bank Board staff is reviewing whether capital requirements should be extended to include other off-balance sheet items.

Disclosure

In addition, the Committee has requested the Board's views on appropriate disclosure and differentiating between institutions through disclosure. Deciding what information to disclose to the public regarding an institution's operations, especially regarding any actual or potential problems it may be facing, requires a careful balancing of competing concerns. On the one hand, the Bank Board recognizes the public's need for information about thrift institutions. On the other, the Board wishes to prevent the instability in a particular institution, or in the industry as a whole, that can result when information is disseminated but misinterpreted. In an effort to address both these concerns, the Board has drawn careful limits with respect to the disclosure of information to the public.

For savings and loan associations and savings banks that are subject to the Securities Exchange Act of 1934 ("'34 Act"), a comprehensive disclosure regime requires full disclosure of material information concerning the institution to its stockholders and the investing public. The Bank Board vigorously enforces the disclosure requirements of the '34 Act with respect to the institutions for which the Board has '34 Act jurisdiction. The Board has been successful in obtaining compliance through the use of informal directives, supervisory agreements, and cease-and-desist orders, and in virtually all cases it has not been necessary to resort to civil injunction actions in order to achieve compliance. These enforcement proceedings are not kept confidential, and it has been the Board's practice to generally disclose publicly the results of enforcement actions taken with regard to compliance with the '34 Act, as well as the Board's stock conversion regulation and Change in Control Act. In addition, the Board's Washington staff works with the Board's network of supervisory agents to verify the accuracy of information disclosed in required reports to the Board. Thus, with respect to '34 Act institutions, the Board maintains an active program to insure that institutions make appropriate and timely public disclosures of material information and a vigorous compliance program, which includes publicity of enforcement actions taken.

All institutions the Board supervises are required to submit, on a quarterly basis, a complete balance sheet and income and expense statement including data on brokered funds, types of deposits and borrowings, outstanding mortgage loans and composition of net worth. The Board publishes this information in the aggregate. In addition, although the Board does not make all this data publicly available with regard to each institution, the public can obtain much of it for a small processing fee.

With respect to other types of enforcement proceedings, the Bank Board is not required to disclose information concerning cease-and-desist or removal/prohibition proceedings. Instead, these administrative proceedings are confidential unless the Board determines, after considering the views of the party afforded a hearing, that disclosure is in the public interest.1/

The Bank Board is, of course, aware of the FDIC's proposed policy for issuing press releases containing information about enforcement orders against state nonmember banks.2/ For the following reasons, however, the Board believes that the likely adverse effects of applying such a disclosure policy to the thrift industry would far outweigh any potential benefits.

First, broad disclosure of enforcement orders would likely lead to misunderstandings that would erode public confidence in the institution affected by an order, whether or not the order related to the institution's financial health. Many types of enforcement orders carry no implications concerning a thrift's soundness; examples of such orders include those relating to the stock conversion or proxy rules, Regulation Z disclosures to borrowers, and accounting and bookkeeping requirements for loans. Yet, consumers could easily misinterpret such an order as a sign of an institution's ill health. When consumers act on such misinterpretations by withdrawing their funds, public confidence in the institution is needlessly lost, and it suffers financially from the withdrawals.

1/ 12 U.S. C. §§ 1464(d)(7)(A) and 1730(j)(1) (1982).

2/ Statement of Policy Regarding Disclosure by the FDIC of Statutory Enforcement Actions, 50 Fed. Reg. 20,609 (1985).

Even when an enforcement order does concern activity that relates to a thrift's viability, the existence of the order usually means that the Bank Board has already taken effective steps to protect the institution from further harm. In such circumstances, the consumer with savings at or below the maximum amount for federal insurance coverage is insulated from loss not only by the insurance fund but by the remedial effect of the enforcement order.

Second, a broad disclosure policy would likely discourage institutions from entering into enforcement orders by consent. Knowing that adverse publicity will result no matter what course of action it takes, an institution may well decide that it has little to lose by choosing to engage in a protracted enforcement proceeding. Of course, this result would further delay beneficial remedial action and would tax the agency's limited enforcement resources. In addition, it runs counter to one goal of deregulation, which should be to encourage voluntary compliance with applicable rules whenever possible.

Finally, without assurances of confidentiality, many institutions may be reluctant to cooperate fully in providing examiners with the information necessary to complete their task. Broad disclosure will certainly encourage the industry to take a more adversarial posture with regard to its regulators. In such a climate, information will be harder to obtain, rendering the examination process slower, making the early detection and resolution of an institution's financial problems much less likely.

In the Board's view, adequate information is already available to the public. Broader disclosure concerning sensitive financial statements and enforcement orders poses the grave risk of increasing the difficulty of the regulatory task. Ultimately, broader disclosure could undermine the efficiency of supervision to ensure safety and soundness of insured institutions, and seriously jeopardize the stability of the thrift industry. The Board believes therefore that it should continue to address disclosure issues on a case-by-case basis so that it may carefully balance the sometimes conflicting concerns of public disclosure and effective supervisory and enforcement actions.

Enforcement Activities and Policy Guidelines

Another area the Committee requested the Bank Board to address is the type of policy guidelines that should exist for enforcement actions. Over the years, the Board has continually attempted to advise its Supervisory Agents when they should seek various types of corrective actions to resolve problems encountered at insured institutions. All such guidelines are necessarily subjective because only human judgment can resolve these questions.

Whether a violation of regulation deserves a cautionary letter, a supervisory agreement, or a cease-and-desist order depends on the factual circumstances surrounding the violation. Was it repetitive, willful, or of serious financial impact? Or was it the result of an error by one officer who has since been better trained or replaced? It may be safe to say that first-time violations by institutions that demonstrate a willingness to correct problems need not result in a formal enforcement order. However, even an inadvertent violation that produces substantial financial loss or the potential for such loss may well dictate a formal rather than an informal response.

The Bank Board follows two absolute guidelines in this respect. The first is that all significant problems and concerns revealed by examinations, monitoring efforts, or other means should be brought to the attention of the institution in a timely manner and some form of assurance that future compliance will result should be obtained. Secondly, any refusal to provide the assurance of future compliance or any significant violation of an assurance, once given, should result in the timely initiation of a more formal enforcement response. The Bank Board follows both of these guidelines by directing immediate and effective supervisory responses to all material violations of laws and regulations. To enable the directives to become a reality, the Bank Board has substantially increased the number of examiners and supervisory personnel at each Federal Home Loan Bank and has created a separate and expanded Office of Enforcement to better address the more serious supervisory problems that demand formal enforcement action.

Thrift Closure Guidelines and Needed Legislative Changes

The third area of the Committee's request seeks the Bank Board's comments on the issue of when a thrift should be closed and the appropriate steps to be taken to manage the failed institution to minimize the effect of such failure on the FSLIC fund.

The FSLIC has a variety of options at its disposal for dealing with a troubled S&L under its current authority when there has been a substantial depletion of assets and insolvency. These options include the appointment of a conservator, affecting a supervisory merger with a healthy institution, appointment of a receiver and liquidation. The standards for the appointment of a receiver and conservator are contained in 12 U.S.C. 1464(d)(6)(A) and 12 U.S.C. 1729(c)(2)(B). These provisions give the Bank Board as the operating head of FSLIC the right to appoint a receiver or conservator for an insured institution based on any one or a combination of the following findings:

1. Insolvency, in that the assets of the association are less than its obligations to its creditors and others, including its members;
2. Unsafe and unsound condition to transact business; or
3. Substantial dissipation of assets due to regulatory violations or unsafe or unsound practices.

In the case of a federal association, the Board has two additional grounds for appontment of a receiver: failure to disclose books and records, or willful violation of a cease-and-desist order which has become final.

Using these statutory bases, the Board has in the past placed institutions into conservatorship or affected a supervisory merger prior to an institution's technical insolvency. The Board believes, however, that its ability to handle problem thrifts would be enhanced by a clarification of existing authority to allow the Board to define through rulemaking what constitutes an "unsafe or unsound condition to transact business" or a "substantial dissipation of assets" in order to more fully carry out the purposes of the National Housing Act ("NHA"). Such a clarification will eliminate any possible ambiguity which could undercut the Board's flexibility in dealing most quickly and effectively with weakened institutions.

Management of Failed Institutions

The proper management of a failed or failing institution is dependent on a number of factors resulting in a unique analysis for each institution. Failed thrifts must be approached on a case-by-case basis. The most important goal of the Bank Board and the FSLIC in managing a failed institution is to do so in the most cost effective way that results in a safe and sound institution. The simplest solution for an association which has significantly depleted its net worth is to have the owners inject additional capital. This can be accomplished through the capital markets or by direct infusion. While it is generally easier for stock institutions to raise capital than mutuals, the conditions for either in the capital markets are not favorable and generally this approach is not available.

Depending on the type of problem the institution is facing, the FSLIC can take several approaches. If the institution is merely experiencing a temporary liquidity problem, the institution's Federal Home Loan Bank can provide cash advances. Other failing institutions may be appropriate merger candidates with little or no assistance from the FSLIC. Merger or sale is the preferable method of handling failed institutions because even if some FSLIC assistance is required, all depositors of the institution are protected, not just the insured depositors.

Another approach for handling a failing thrift is the "Management Consignment Program" (MCP), whereby qualified, healthy institutions are engaged to assist in the stabilization and possible rehabilitation of the thrift. Use of this program greatly reduces the costs to the FSLIC and allows for the orderly "workout" of large FSLIC cases.

The last available option employed by the Board and the FSLIC has always been outright liquidation. Liquidation is traditionally the costliest solution to a failed thrift as well as the solution with the most serious public ramifications. Not only are liquidations costly, but they require dedication of extensive staff resources. For these reasons, liquidation is rarely the method of choice for handling failed institutions.

Capital Infusions by FSLIC

Another approach to managing troubled institutions is direct assistance from the FSLIC. The Committee has requested the Board's views regarding when infusions of capital by the FSLIC are appropriate. The FSLIC may provide such assistance through use of the net worth certificate program enacted as Title II of the Garn-St Germain Depository Institutions Act of 1982 or through use of other 12 U.S.C. § 1729 powers. In particular, § 1729(f)(1) authorizes the FSLIC to provide assistance if such action is taken to prevent the default of an insured institution, to restore a defaulted institution to normal operation or to lessen a risk posed by an institution to the FSLIC. The provisions of § 1729 were substantially amended in 1982 to afford the FSLIC greater flexibility in handling case resolution, and provide an appropriate framework for the exercise of FSLIC discretion in this regard.

Reducing Costs to FSLIC

In its continuing efforts to efficiently allocate its limited resources, the FSLIC has recently expanded its use of the transfer of accounts method of insurance settlement and achieved significant cost savings with two new approaches. An example of each is the following:

A) Interstate Transfer of Accounts

As the size of institutions being liquidated has increased, bidding for the transfer of insured accounts has been initiated on an interstate basis. Significantly larger discounts have been received from out-of-state institutions.

	Highest In-State Bid	Highest Out of State Bid	$ Savings
San Marino	1/2 of 1%	7.1%	17 mil.
State of Utah*			25.1 mil.
Hawaii Division	None	5.6	17.6 mil.
Utah Division	1.75	8.37	7.5 mil.

*Note - A larger bid was submitted for the combined operation. However, it had provisions which were not acceptable to the Board.

B) Creation of a "New Federal"

In November 1984, the insured accounts of five Tennessee associations were simultaneously transferred into New Federal Savings and Loan Association of Knoxville, a *de novo* Federal association chartered solely for that purpose. This was the first time the FSLIC chartered a new institution for insurance settlement purposes. New Federal was established with assets consisting entirely of cash and FSLIC notes. New Federal was subsequently acquired in April, 1985. In this transaction which involved interstate bidding, FSLIC received a discount of 7.25% ($12 million).

Merger of the FSLIC and the FDIC

The idea of merging the FDIC and the FSLIC has been discussed at length for several years. The Board is strongly opposed to such an action. We believe that such a merger would be unjustified from the standpoint of the FSLIC's financial condition and the recapitalization plan I have outlined today, would diminish the effectiveness of thrift regulation, and would erode the long-term viability of our nation's system of specialized housing lenders.

The two main premises for this proposed merger have been: 1) to reduce duplication, thus theoretically reducing administrative costs; and 2) to increase the security of the FSLIC fund by merging it with the FDIC. Neither premise can be supported in light of the facts.

First, the contrasting purposes and characteristics of the FDIC and the FSLIC argue strongly against a merger of the funds.

The Federal Home Loan Bank system and the Federal Savings and Loan Insurance Corporation (FSLIC) were created in 1932 and 1934, respectively to broaden the financing of home ownership opportunity; to assure millions of small depositors that they could rely upon safe, insured thrifts to hold and accumulate their savings; and to maintain the stability of the home financing and the thrift system in the face of major economic disruptions.

In contrast, the Federal Deposit Insurance Corporation (FDIC) was established in 1933 to insure all national commercial banks, to protect insured funds in the event of a commercial bank failure, and to insure the stability of the commercial banking system.

The FSLIC and the FDIC, then, were created as two separate insurance funds operating under separate and distinct regulations and serving different public needs. The history of the FSLIC fund has been one of continuously insuring the availability of economical home financing to millions of homeowners in compliance with its Congressional mandate.

To merge these two separate funds, then, would be to create a homogeneous entity to regulate two heterogeneous funds and industries.

Today, federally-insured thrifts and banks, and the regulatory structures which support them, continue to diverge markedly in terms of the functions each provides in our economy. Despite asset deregulation at the state and federal levels for thrifts, fundamental substantive differences between S&Ls and commercial banks remain, and will remain. Insurance risks, regulatory status, and assistance techniques are quite different for each industry, and will remain so given their different functions.

As such, it should also be noted that there are substantive differences between the current system for insuring S&Ls and that for commercial banks. Commercial banks are influenced by federal government policies in the areas of chartering, insurance, examination and supervision, liquidity and regulation of activities. These functions are divided among the Federal Reserve System, the Comptroller of the Currency, and the FDIC. In the case of a default prevention situation, action requires coordination by these three agencies, which have different objectives and different philosophies. Coordinated action is sometimes slow and difficult to achieve.

In contrast, S&Ls have all of these government functions provided by a single agency--the Federal Home Loan Bank Board. Governmental handling of default prevention cases is greatly facilitated by having a single agency with a single approach and objective in charge. To consolidate the FSLIC insurance functions into an agency with primary experience in supervising and insuring commercial lending entities would destroy this advantage with respect to S&Ls. It is also extremely doubtful whether it would eliminate any duplication since it would primarily consolidate a number of diverse activities under one agency.

If the FDIC and the FSLIC were merged and funds were diverted from the FDIC and its constituent banks to resolve failed thrift institutions, it would seem to follow that commercial banks might wish to impose equal regulatory requirements on all insured institutions. This, in turn, would surely entail requirements which could cause thrift institutions to reduce their commitment to housing finance in order to compete with commercial banks. This competition might radically alter the availability of long term, low cost housing finance in this country and pose a substantial threat to the continued existence of the thrift industry.

The Bank Board believes that the substantive differences between S&Ls and commercial banks will remain despite S&Ls' broadened asset and liability powers. Identifiable specialized institutions will continue to constitute the vast bulk of each of the two industries as insurance risks, regulatory status, and assistance techniques are quite different for each industry.

Furthermore, from a public policy standpoint, the merger of the funds would be an indirect way by which Congress would alter its fifty-year commitment to housing finance represented by federally insured thrift institutions.

Finally, we believe it is important to note that the Vice President's *Report of the Task Group on Regulation of Financial Services* exhaustively studied this issue and similarly concluded in favor of retaining a separate FSLIC.

Given these considerations, the Board believes that it would be most beneficial to address the issues of insurance reform independently for the thrift and banking industries. In so doing, we will also act to preserve and build the integrity of both the federal deposit insurance funds.

The Role of Private Insurance

The final issue which the Committee asked the Bank Board to address concerns the role of private insurance and whether that role should be faciliated. While the concept of private insurance is attractive in theory, it would appear that private plans are unworkable in today's environment, and indeed, few private plans still exist. Events in Ohio and Maryland with state-sponsored, private insurance funds have unquestionably affected the public's perception of these plans. The failure of these private funds also created significant instability in the financial markets. The Bank Board believes that universal federal deposit insurance is essential to maintain a sound and stable financial system in a volatile deregulated environment.

As the cornerstone of America's financial system, federally-insured depository institutions are unique private sector instruments of public policy. The very stability of our financial system is largely dependent upon public confidence in the system of banks and thrifts insured by the FDIC and the FSLIC. The nation's FSLIC-insured savings institutions are members of the Federal Home Loan Bank System, a separate and distinct credit, deposit insurance, and regulatory apparatus. Acting in its surrogate role for Congress, the system is governed by the Federal Home Loan Bank Board.

The public policy underpinning and rationale for the Federal Home Loan Bank System were established in the Federal Home Loan Bank Act of 1932, the Homeowners Loan Act of 1933, and the National Housing Act of 1934, which created and still governs, membership in the FSLIC. Thus, this model system has served the country well for more than a half century, and, its existence has had more to do with making America a nation of homeowners than any other single factor.

Federally insured savings institutions, with their principal statutory purpose of providing home financing are the beneficiaries of a public policy with the established advantages of soliciting operating funds through marketing the FSLIC insurance seal of protection. Indeed, all federally insured depository institutions enjoy that unique advantage in their solicitation of funds with which to carry out their operations. This enables such institutions to operate on the implicit, if not explicit, full faith and credit of the United States, thereby substaining public confidence in federally insured depository institutions. By maintaining confidence in our depository institutions, the system of federal deposit insurance has served, and is serving, to support them.

To date, no insured depositor has lost a penny as the result of a failure of a depository institution that was insured by the FSLIC, the FDIC or the National Credit Union Share Insurance Fund. While the great success of federal deposit insurance has been enjoyed by more than 90 percent of deposit-taking institutions, not all institutions have desired or qualified for federal deposit insurance. In a decreasing number of states, banks and thrift institutions have had the option of participating in private, industry-financed deposit insurance systems. The "advantage" of private insurance over federal insurance is to permit operation with less regulation and supervision, thereby allowing payment of higher rates of interest on deposits. The disadvantages were painfully illustrated recently as hundreds of thousands of depositors experienced tremendous turmoil and anxiety in the states of Ohio and Maryland. Ultimately, that turmoil -- and the panic that sparked runs on institutions throughout those states -- abated in large part only because of the ability of the federal deposit insurance agencies to quickly examine and admit to federal insurance large numbers of those privately insured entities.

One of the reasons we have federal insurance is that many depositors cannot distinguish between sound and unsound depository institutions. In assessing the degrees of financial safety, the full faith and credit of the United States offers the best credit risk, and accordingly, the best guide to institutional soundness for protection of the average depositor. Confusion over the nature of private insurance funds, mistakenly believed by some to be state-backed or backed by the full-faith and credit of the United States, detracts from the ability of the public to distinguish between sound and unsound institutions. The Ohio and Maryland crises demonstrate that a person who places money in a depository institution ought to know the true nature of the insurance backing that institution, as well as the regulatory apparatus governing that insurance.

Absent a statutory mandate for universal federal deposit insurance, there is every likelihood that runs similar to those in Ohio and Maryland could necessitate more *ad hoc* rescue efforts by the federal insurors. Universal federal deposit insurance is preferable to such a scenario for a number of reasons. While we are generally aware of some financial statistics behind the state authorized private insurance funds, we do not know the true financial condition of the thrift institutions insured by these funds. Privately insured thrift institutions are totally exempted from all federal regulations, and consequently, they are not required to report their financial condition to federal regulators nor to subject their books and operations to the scrutiny of federal savings institution bank examiners. In short, these institutions have no connection with the federal government, and the federal government, in turn, has no means of assessing the financial viability of these institutions.

Furthermore, analyzing financial institutions depends not only on the condition reflected in pro forma financial statements, but also on the quality of examination and supervision those institutions receive. On a straight accounting basis, Home State Savings Bank of Ohio appeared to be adequately capitalized. On the other hand, due to what may have been lax supervision, that institution was allowed to take tremendous risk by borrowing almost 50 percent of its funds through a single government securities dealer --E.S.M.

Without our being able to scrutinize the adequacy of the examination and supervision process in states permitting private deposit insurance funds, we have no way at all of determining the soundness or financial integrity of these funds, nor can we vouch for the accuracy of the financial statistics provided by the affected institutions. In turn, with such a system of private insurance, we cannot continue to maintain a high level of public confidence in those institutions without federal deposit insurance nor can we prevent a fallout effect potentially draining confidence from all depository institutions for those who fail to distinguish between federal and other types of insurance.

Changes are required now because experience has exposed these problems in the present System. Uninsured depositors in small failed banks have sometimes suffered losses while such depositors in larger failed banks have not.

In short, the System is not operating in a fair manner in certain cases.

Second, essential tools for a smoother and more efficient handling of large bank failures must be created. Lack of such tools results in solutions such as Continental-Illinois, where holding company creditors were protected and some stockowner interest, which was unnecessary, was preserved.

Third, additional mechanisms for handling bank failures are needed so that bank failures will not require large liquidations of assets by the FDIC, which cut off borrowers from banking services.

Fourth, the current assessment of the System is unsatisfactory and unfair. It doesn't charge higher premiums to those institutions that expose the insurer to greater risk.

In addition, it provides free de facto insurance coverage to some bank creditors. These problems create an immediate need for deposit insurance reform. To meet these problems we favor changes in permissible acquisitions so that, where feasible, private sector solutions are encouraged based on our experience and analysis. That will be discussed in detail in my written text.

We do not believe that, at this time, consistent use of the modified payoff is a feasible way to deal with bank failures or to rectify the fairness problem. Rather, we propose legislative changes and modified procedures to effect purchase and assumption transactions more frequently.

It might be appropriate to reconsider modified payoffs at such time as a practical uniform system can be developed, and financial markets become less vulnerable to the large effect on the System of such payoffs.

FDIC NEEDS FLEXIBILITY ON FAILED INSTITUTIONS

We will try to sell as many assets as possible to an acquiring bank to lessen the FDIC's direct involvement in liquidation. We propose that the FDIC be given increased flexibility to take control of failed institutions, so that the FDIC has more time to arrange a satisfactory merger or acquisition for a failing institution. Thus more time to deal with failures is the essence of one of the central reforms of the system.

Specifically, we recommend the following legislation:

The interstate acquisition provisions of the Garn-St Germain Act, scheduled to expire on April 5, be extended and broadened to include failing banks as determined by the chartering authorities, as well as failed banks and to also include the interstate marketing of multibank holding companies, where a bank representing a significant share of the holding company's assets is in danger of failing.

Second, the enactment of a Federal deposit or preference statute that would be applicable to State, as well as federally chartered institutions. This is needed to facilitate increased use of purchase and assumption transaction. It will lessen the cost of handling bank failures and could lead to a disciplining role for certain classes of bank creditors.

Next, Federal legislation to provide the FDIC with conservatorship powers, to provide more time to dispose of failing banks and pass current assets in the process.

We need Federal legislation that would allow the FDIC to establish a bridge bank for a limited period of time to facilitate the repositioning and dispositing of a very large bank that has failed.

Federal legislation that would allow the FDIC to implement a risk-based deposit insurance system would charge banks exhibiting higher risk characteristics as defined by an objective system and insurance premium up to twice the rate charged other institutions. Federal tax legislation to encourage the acquisition of failing institutions by exempting from tax FDIC assistance in such transactions.

Federal legislation ensuring that adequate bank supervision is provided by responsible, independent agencies. We are convinced that bank supervision must play an even larger role in monitoring risk and reducing the exposure of the Federal deposit insurance system and not expose our economy to unnecessary risk.

Supervision must be increased as deregulation provides bankers with a needed opportunity to use their judgment in making business decisions.

For the first time in over 50 years, the Office of Management and Budget has asserted new jurisdiction over three of the four regulatory agencies, changing half a century of independent operation. The Congress should review this issue promptly and assure that the traditional independence of the operations of the Comptroller, the Bank Board and the FDIC will be continued. To fail to continue that could materially affect our effectiveness to operate the system.

Finally, let me talk about the financial condition of the FDIC. Among the current concerns about Federal deposit insurance are the financial conditions of the funds and the adequacy of their reserves now and in the future. There has been much discussion about the FSLIC, a swell. At this juncture, I prefer to let my colleague, Chairman Gray, and other public and private leaders, discuss the condition of their fund.

I will confine my remarks to the FDIC. The FDIC's insurance fund is adequate to handle the problems of the day and those likely to be faced in the near future. The Federal deposit insurance fund's net worth is currently about $18 billion and assets include about $16 billion of U.S. Treasury certificates.

FDIC FUND REMAINS HIGH

The size of the fund, relative to insured and total deposit liabilities of banks remains high by historical standards. The fund is currently 1.22 percent of insured deposits, well above the average, for the past 10 years. The fund's growth during the past 2 years has slowed as the result of losses and reserves established in connection with increased bank failures.

These losses have resulted in insured banks receiving only a small assessment rebate for 1983 and 1984. They received no rebate for 1985, although to a large extent this reflects higher losses in failures which occurred prior to 1985.

In that regard, we have restated our 1984 statements to include the appropriate losses of Continental Illinois, as indicated desirable by the GAO, and if those losses had been reflected in 1984, there would have been no rebate in that year.

Last week, the FDIC added $3.2 billion to its allowance for insurance losses; however, only $600 million of that related to 1985 failures. The $1.3 billion related to the 1984 system transaction with Continental Illinois Corp. and $700 million of that loss was charged to the 1984 operations which were restated by the FDIC.

While the Continental Illinois transaction still has several years to run, our loss reserves reflect our assessment of likely ultimate loss on the loans that might be put to the FDIC, exclusive of potential gains or losses on our stock investment in Continental.

It is important to emphasize, we attempted to conservatively account for all projected losses and commitments related to failures and assistance transactions and have carried our reserve up to yearend. This includes estimates of our ultimate losses and assets acquired in connection with all failures, as well as losses related to commitments connected with assisted mergers.

We have also established reserves for those savings banks with outstanding net worth certificates, where the FDIC seems likely to incur a loss. I believe that the FDIC's balance sheet conservatively reflects our exposure from past bank failures. It is, of course, more difficult to be absolutely certain about the adequacy of our reserves for meeting future failures. Nevertheless, past experience suggests the current reserves are adequate.

While we believe the Federal Deposit Insurance Fund and the basic assessment rate for satisfactorily performing banks are adequate at present, the assessment system and the long-run strength of the fund will be materially enhanced by enactment of our recommendation for deposit insurance reform.

In summary, while our fund is coping with today's rapidly changing and difficult conditions in the banking field, we urge action to help the insurance system be better prepared for future challenges. One never knows how far in the future they may be. We need powers to assure that the System can reduce losses and protect financial stability in the case of major bank failures, powers to help us provide equal treatment for all banks large and small that fail, powers to allow more time in handling failed and failing banks, in order to aid in reducing the trauma of bank failures, for powers by keeping their loans in the banking system and to reduce losses to the FDIC, powers to impose punitive costs on those institutions that operate in a high-risk manner and are thus likely to be costly users of our insurance, powers to operate in our traditional role as an independent agency under congressional supervision.

The FDIC is sound. To keep it that way, we need new tools, which only the Congress can provide us.

Thank you.

[The complete prepared statement follows.]

STATEMENT ON

DEPOSIT INSURANCE REFORM

PRESENTED TO

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

BY

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Room SD-538, Dirksen Senate Office Building
March 13, 1986
9:30 a.m.

Mr. Chairman, I am pleased to have an opportunity to appear before this committee to discuss deposit insurance reform. You have held a number of hearings where a great many views on this subject have been expressed. We have considered these and our own experience, especially our recent experience. We at the FDIC have concluded that, while the basic deposit insurance system is performing well, there is an urgent need for selective change.

In my testimony, I will indicate where I believe changes are necessary. These changes will include those requiring Federal legislation, those requiring state legislation and those that can be implemented by the FDIC under existing law.

Last year there were 120 bank failures and FDIC-assisted mergers and, very likely, we will see at least that many this year. In 1984 there were 79 bank failures; in 1983, 48; and in 1982, 42. During the entire decade of the 1970s there were only 76 bank failures. As of March 3, there were 1,196 banks on the FDIC's problem list. This number has increased steadily since the spring of 1981, when there were 200 banks on the problem list. This dramatic change has provoked many questions about the condition of the banking system, the handling of bank failures, the role that deposit insurance has played and the role that it should play in the future.

Banking System Problems

Bank failures have increased primarily because of weaknesses in the economy. While the overall economy has performed well during the past three years, performance has been uneven, leaving some parts of the country and some industries especially depressed. Weaknesses are likely to persist during the next year or more in energy and agriculture and in several foreign countries that are significant bank borrowers, and parts of the banking system will continue to be hurt by these strains.

During this same period, the banking environment has undergone considerable change. Deposit rate ceilings were deregulated. Competition among domestic banks and between banks and other institutions (including foreign banks competing in the U.S.) has increased. The effect of increased competition has been uneven; in some cases, banks previously insulated from competition have encountered significantly reduced margins in the marketplace; some banks have seen investments in branches and other facilities become redundant in the face of technological change and greater price competition.

Economic and competitive forces have made it more difficult for some banks to operate profitably. In some instances, reduced spreads on safe activities induced banks to take more risk and this led to increased loan losses. Years of operating in a very comfortable economic and competitive environment may have led some banks to become complacent in assessing risk and controlling expenses. An exact distribution of the causes of current problems is not possible. In our system, such problems are exacerbated by branching and other geographic restrictions which limit diversification possibilities for banks and lead to excessive exposure to a single industry.

Banks and regulators are adjusting to what has been happening. There is considerable evidence that banks are placing more stress on loan quality. And regulators have sought to get on top of problems earlier, especially in the case of large banks. However, many of the current problems will be around for some time, and they may get worse. They reflect weaknesses in existing loans on the books of banks and weakened financial conditions of those borrowers.

Deposit Insurance

What has been the role of deposit insurance in this process? The existence of high deposit insurance coverage (including what is perceived to be 100 percent de facto coverage for large banks) has probably contributed to expansion and precarious funding by some banks. While some maintain that high insurance coverage has contributed to risk taking, I doubt that deposit insurance has been a major contributor to the problems we currently face. For that reason I do not believe the system is in need of fundamental change that would impose greater risk on depositors or substantially increase capital requirements of banks.

The insurance system has been seriously tested in recent years and for the most part it has performed well. Federal deposit insurance has fully protected most (though not all) depositors from bank failures; it has significantly reduced disruptions associated with bank failures; and it has generally preserved confidence in the banking system.

Clearly, the system has not performed perfectly, and this has become more apparent as the number of failures has increased. Problems in the insurance system have been identified in at least four areas:

- The operation of the deposit insurance system has not always treated similar depositors in large and small banks in the same way, causing some to assert that the system is not altogether fair.

- While the insurance system has lessened secondary effects of failures, the current methods of handling of bank failures may have placed too many assets in a liquidation mode, cutting off borrowers from bank services and, possibly, increasing the cost of handling failures.

- The current system does not provide the FDIC with all the essential tools for smooth, efficient handling of large bank failures.

- The system does not provide a means of assessing those institutions that expose it to greater risk a premium that is commensurate with that risk. Additionally, the current system and the manner in which failed banks have been handled has sometimes given a free ride to some bank creditors -- they receive the benefits of deposit insurance without paying for it.

Of course, we operate with certain handicaps in the banking system that sometimes make private sector resolution of problems through acquisitions more difficult. In some states, branching restrictions significantly limit the feasibility or practicality of one bank acquiring another, failing, institution. Limitations on interstate acquisitions substantially reduce options in dealing with large, troubled banks. And in some instances, limitations on what banks can do limit the attractiveness of bank charters and of banks as acquisition candidates.

During the remainder of my statement I will address in greater detail each of the suggested weaknesses in the deposit insurance system and how I propose the system be improved. In several key areas, I believe, Federal legislation is needed. In some instances changes in FDIC procedures within our existing statutory authority are necessary. I will also discuss some proposed "reforms" which I consider to be unnecessary or counterproductive at the present time. My recommendations will focus on practical ways to improve failure management and on ways to improve the efficiency and fairness of the insurance system.

Fairness Issue

During the past 20 years a majority of bank failures and all failures of large banks (those with assets over $500 million) have been handled through purchase and assumption transactions (P&As). In these transactions all deposit and most other liabilities to general creditors[1] are assumed by an acquiring bank so that such creditors come out whole regardless of the size of their claim. In contrast, when a bank is liquidated through a payoff, only insured depositors are paid by the FDIC. Uninsured depositors, the FDIC (standing in place of insured depositors) and other general creditors, are paid pro rata from the proceeds of receivership collections. In most cases they do not receive the full amount of their claims. Thus, uninsured depositors and other general creditors are not likely to come out whole in a payoff, whereas they do in a P&A.

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[1] The exception has been general creditor obligations, where they exist, in state-chartered banks located in states that have depositor preference statutes.

Most payoffs have occurred when there have been no institutions interested in acquiring the failed bank (typically where branching is restricted) or where fraud or contingent liabilities have made it extremely difficult for the FDIC to estimate loss and effect a P&A. Until the Penn Square Bank, N.A., in Oklahoma City was paid off, the largest bank paid off by the FDIC had liabilities of less than $100 million.

Modified Payoff

In the spring of 1984, the FDIC effected a number of so-called modified payoff transactions. Failing banks were closed and insured depositors were paid. However, the form of payment was the transfer of their accounts to another institution which usually acquired the premises and certain other assets of the failed bank. Most checks in process were paid as is done in a P&A and most depositors probably were unaware of the difference. However, the liabilities of uninsured depositors and other general creditors were not assumed by the acquiring bank. The FDIC made a conservative estimate of the present value of future receivership collections and advanced funds to the receivership so that a cash advance could be made almost immediately to uninsured general creditors.

The modified payoff preserved many of the advantages of the P&A transaction. It was less disruptive than a straight payoff, while still retaining some depositor discipline from uninsured depositors and other bank creditors. Some of the value of the failed bank's deposits and facilities were preserved and these were sold through a bid process as in a P&A. The cash advance to uninsured creditors removed some of the "sting" of a reduced payoff, although uninsured depositors were still exposed to some loss. The modified payoff worked from the standpoint of mechanics -- it clearly was superior to a traditional payoff because it conserved FDIC personnel and financial resources and was less disruptive to the community.

The FDIC was in the process of examining the modified payoff in April 1984 when Continental came along and the decision was made not to use a modified payoff. Since then, the modified payoff has been used infrequently, usually in situations where a P&A was not feasible.

Paying off Continental was never considered to be a serious option. The need for a major decision came very quickly. Paying off Continental would have taken a considerable amount of time and caused substantial disruption in financial markets. Mechanically, it did not appear possible to determine all account balances promptly to allow any payments and the amounts involved were too large to be handled in the normal fashion. A substantial volume of depositor, lender and borrower relations would have been disrupted. Moreover, there might have occurred significant liquidity problems for many major U.S. banks and, very likely, some permanent disruptions in borrowing and deposit relations among many financial institutions. Once it became apparent that a giant bank could not be handled as a modified payoff under current technology and market conditions, it seemed unfair to pay off smaller failing banks, and systematically expose large depositors to loss in such institutions.

It is important to note that, even before the Continental situation occurred, many at the FDIC did not consider the modified payoff to be an unqualified success or the way to go in the future. Many were skeptical about "depositor discipline." Depositors generally have ample notice to get out of a troubled bank without incurring any loss. Once unfavorable news becomes public, they have no incentive to stay with a troubled bank, even if they think it is likely to survive and turn itself around. Actually, the increased probability of depositor loss would make it difficult for a troubled bank to turn itself around. Depositor discipline has always been a two-edged sword, which requires considerable disciplining in and of itself.

In the case of a large bank with extensive overseas branches, under current conditions it is doubtful that the FDIC could control the liquidation of assets and the disposition of their proceeds in foreign countries. This further limits the feasibility of effecting a modified payoff for a really large bank.

If we could and did pay off a large failing bank, what would be the impact on the system and on other banks funding primarily through uninsured creditors? Lots of assets would be tied up in liquidation as would the claims of many depositors and lenders. Flights of deposits from large institutions perceived to be at risk might be considerable. So, too, would be the potential disruption and risk to the system. Some say we eventually would have a better system, although they might concede that it may be difficult or impossible to get from here to there. I'm not so sure it would be a better system. It is apt to be more unstable and depositor discipline has its limits in an environment where most liabilities are very, very short-term, funds can be readily transferred, leverage is substantial, and information is easily transmitted. After all, the FDIC and the Federal Reserve System were created because of the problems of too much depositor discipline at one time. In the future, systems might be developed to pay off large banks more easily and the banking environment might become less vulnerable to large payoffs. At such time, it might be appropriate to revisit depositor discipline.

If universal modified payoffs are neither feasible nor, at the present time, desirable, how can we improve the fairness in the system so that depositors in large and small banks that fail are treated the same? A preferable alternative is to do P&As wherever feasible and eliminate those impediments to effecting them. A principal impediment is restrictive branching statutes which limit potential bidders for failed banks. Since May 1984, when initial assistance was given to Continental, there have been 41 payoffs of failed banks; 36 of these occurred in states that have substantial restrictions on branching.

Partly in response to this situation, several states have liberalized permissible branching in failed bank situations. However, more needs to be done

-- possibly a Federal override permitting the establishment of a branch in connection with a P&A acquisition, regardless of state branching law or permission for the FDIC to charge higher insurance assessments in these states.

Under existing law the FDIC is required to meet a cost test in choosing a P&A over a payoff, selecting the former only in situations where it appears to be the cheaper alternative. Where significant contingent claims exist (liabilities for loan commitments, law suits, off-balance-sheet guarantees, possible unbooked claims, etc.) it becomes extremely difficult to estimate costs. The FDIC typically must protect an acquiring institution from such claims to get them to bid. Should the claims become established as general creditor obligations, the FDIC would have to pay such claims in full, subsequent to a P&A transaction where the failed bank is not subject to a state depositor preference statute. It is frequently difficult to estimate with any precision which contingent claims will ultimately be established, and this complicates estimating P&A costs.

Sometimes a failing bank will have obligations for unsecured borrowings. These general creditor obligations have creditor status equal to depositors where depositor preference is not applicable. In order to do a P&A these obligations must be assumed by an acquiring bank (i.e., they must be given equal treatment to deposits). No deposit insurance premiums are paid on such obligations even though they benefit from the deposit insurance system and the way bank failures are handled.

It is therefore recommended that a Federal depositor preference statute be enacted. This would prefer depositors to other bank creditors,[2] including those creditors who might establish claims in connection with letters of credit, other guaranties, law suits, etc. It would apply to all FDIC-insured banks. This would substantially simplify the FDIC's cost calculations and facilitate satisfying the P&A cost test; it would reduce the cost of handling failed banks; it may result in increased FDIC assessment income; and, in some instances, it would create a class of creditor which might serve to discipline banks and monitor risk.

This is an important proposal that has implications for remedying to some degree each of the problem areas I have suggested exist within the deposit insurance system.

In a P&A under depositor preference, an acquiring bank could only assume deposit liabilities. The FDIC would be entitled to recoup its outlays (including foregone interest) before nondeposit claimants receive anything. This would probably cause some realignment of creditor relationships. Some loans to banks might be shifted to deposits -- but the bank would then be required to pay insurance premiums on them. Standby letters of credit or other guaranties from weak institutions would have diminished marketability, and this would be a salutary development.

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[2] It may be appropriate to place liabilities related to employment and other similar services on a par with deposits. An alternate version of this proposal would involve three categories of preferences: deposits, balance sheet liabilities, and contingent claims.

A depositor preference statute would reduce the FDIC's cost in handling bank failures and make it considerably easier to meet the cost test necessary to justify a P&A. It would also mean that general creditors would look carefully at the financial position of the banks, thus creating an increased element of market discipline on the institution.

A depositor preference statute would raise some interesting questions with respect to certain existing bank liabilities. Some institutions have resorted to collateralized nondeposit borrowing as a means of raising funds cheaply in the marketplace. If the collateral is substantial, such borrowings would acquire a preferred status in liquidation and this could weaken the FDIC's creditor position, raising FDIC losses. It may be appropriate for such borrowings to be treated as deposits for purposes of calculating deposit insurance premiums so that they not become a vehicle for circumventing that expense of operation.

The treatment of foreign branch deposits is an issue of greater quantitative importance. Foreign branch deposits currently exceed $300 billion, account for about 15 percent of bank deposits and a much larger percentage for money center banks. If we prefer foreign deposits to other bank creditors like domestic deposits, they should be subject to insurance assessments. An alternative would be to prefer domestic deposits and not subject deposits in foreign branches to assessment. This would expose them to increased risk in the event of failure (they would be outside the P&A process). While foreign central banks might control the liquidation of overseas assets and affect the status of creditors, there might still be considerable uncertainty about the position of overseas deposits.

Disposition of Failed Bank Assets

The FDIC needs legislation which will provide it with more time to handle failed or failing institutions. In a P&A transaction the FDIC has generally provided an acquiring bank with book assets, less a premium that is bid, equal to assumed liabilities. The makeup of book assets has varied. Until recently, most P&As were relatively "clean." Book assets assumed consisted of physical facilities (appraised value), securities at market value, performing installment loans and, sometimes, residential real estate loans. To bring assets up to assumed liabilities (less premium), the FDIC inserted cash, removing classified loans and most or all commercial loans. This "clean bank" P&A simplified the bidding process and minimized the burden placed on bidding banks. However, it left the FDIC with a considerable loan collection task. In some instances, values associated with ongoing loan relationships were lost and this also probably cost the FDIC.

Those borrowers who were not sufficiently strong or established may have had difficulty getting new financing to pay off the FDIC. In its liquidation capacity the FDIC is naturally reluctant to provide additional financing to borrowers in situations where a bank holding a similar loan might be willing to provide such financing. Thus, borrowers may be cut off from needed banking services and, ultimately, the loss to the FDIC not only may be increased, but the economic activity in the area may be reduced.

Since last spring the FDIC has sought to pass more assets in P&As. In current P&A transactions most performing loans of all types are initially passed. The acquiring bank is typically given an opportunity to put back some share of such loans to the FDIC at book value within the first few months of the transaction. Some additional loans can be sold back to the FDIC at a discount. These changes have served to reduce the volume of assets our Liquidation Division acquires from failed banks. Nevertheless, the FDIC still acquired about 35 percent of the loans of banks that failed last year. (We currently own about $9 billion in book value loans taken in connection with bank failures and assistance transactions.) We expect the changes to reduce losses associated with handling failed banks because marginal loans are likely to have greater value in the hands of banks where financing is available.

We are currently reevaluating our policies and developing procedures and incentives to pass not only all unclassified loans, but pass or develop incentive arrangements so that collections on nonperforming loans can be done by acquiring banks or other private institutions. This will probably require some testing of new procedures and some imagination. It would be our goal to reduce the cost of handling bank failures, to reduce the FDIC's involvement in collections and in potential adversarial relationships with borrowers and, in some instances, provide borrowers from failing banks with ongoing banking service. To the extent that passing more assets can reduce our cost it will tilt the results of the cost test in the direction of more P&As.

In order to get banks to take more assets of failing banks it will be necessary

to give more information on loan portfolios to failing banks. This would require stretching out the P&A process and, in some cases, keeping a failing bank operating for a longer period of time after potential bidders have been contacted. To prevent a run during this period, the FDIC might put a subordinated note into the failing bank, imposing some restrictive conditions on its operation. However, that may not always be feasible and management of the failing institution may not always be cooperative. For such situations we are considering legislation to enable the FDIC to control the operation of an open institution through conservatorship powers in order to provide time for potential bidders to review the bank's loan portfolio.[3] This could ultimately reduce the cost and disruption of disposing of a failing bank. Under certain circumstances, where the range of potential bidders is large (say, where interstate acquisitions are feasible), a satisfactory shopping process could lead to the disposition of the bank with minimal FDIC financial involvement and, possibly, on an open bank basis.

As regional and interstate banking become the pattern in the country, more time to assemble bidders is necessary, and this further argues for providing more time for the FDIC.

Large Bank Failures

Over the past two decades, several large banks have failed, received direct assistance to avert failure or been merged while on the brink of failure. These transactions have involved special arrangements, emergency state legislation and difficult negotiations in an uncertain environment. Available options have sometimes been limited. Several changes are needed, I believe, to increase options and provide for more flexibility to handle future failures of large banks.

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[3] In the case of some failing banks, including those with significant contingent liabilities, it may be preferable to have the FDIC keep the bank's operations intact by means of a "bridge bank", as described below.

Ideally, when a large bank gets into difficulty, the resolution of its problems would be handled through recapitalization or a private sector merger. And, ideally, supervisory pressure will be applied early enough so that FDIC assistance isn't necessary to solve the problem. However, restrictions on interstate branching and acquisitions frequently limit options for private sector solutions (as I have suggested, branching and geographic restrictions also contribute to concentrations and the development of problems in the first place). Interstate compacts enacted by states have materially expanded options. However, they still don't go far enough. The Garn-St Germain Act of 1982 provides for interstate acquisitions of failed banks with assets of $500 million or more. That provision has materially increased FDIC options in several bank failures. Last month the interstate provision was used in a Florida failure and the provision has apparently saved the FDIC a substantial amount of money. The interstate provision of Garn-St Germain is scheduled to expire April 15 and it is very important that, at a minimum, Congress extend that provision. However, we believe the interstate provision should be materially broadened.

Once a bank fails, its value to a potential acquiror is substantially diminished. FDIC options are reduced and potential costs are materially increased.

We recommend that Congress permit the interstate acquisition of failing banks that have assets of $250 million or more.

In restrictive branching states the value of out-of-state entry may be very limited if the subsequent acquisition of other institutions in the state is not permitted. If a large bank is part of a holding company system, failure of that bank would only permit the interstate acquisition of that single-office institution under existing law as opposed to the other parts of the holding company. In such a situation it would be logical to permit the interstate acquisition of bank holding companies where one or more banks in the system is in danger of failing, the bank(s) satisfy the size requirement, and the failing institution(s) account for a significant share of the holding company assets. Another approach would be to permit the interstate acquisition of one or more failing banks, and thereafter allow the acquiror the same expansion rights enjoyed by banks or bank holding companies within the state.

The extension of the interstate acquisition provision to include failing banks and also bank holding companies would enable these institutions to actively shop for mergers with out-of-state and foreign banking institutions while there is still some chance of saving the institution without FDIC involvement. That could substantially lessen our task and conserve on our financial and personnel resources. In some instances, FDIC assistance may be necessary to effect a transaction. However, that is likely to be considerably less than the cost to the FDIC if we wait for the institution to close. Even where an open bank transaction is not possible, the shopping process will materially increase the amount of information available to potential bidders and facilitate a closed bank transaction.

When a very large bank fails, options may still be very limited, even when interstate and international possibilities are considered. That was evident in the Continental assistance transaction. It will be difficult to put together a satisfactory purchase and assumption in a short period of time unless the FDIC is willing to buy out a substantial volume of troubled assets, an option which is not desirable.

What is needed in these circumstances is a method to "bridge" the gap between the failed bank and an orderly purchase and assumption transaction in which the FDIC does not have ongoing responsibilities for many troubled assets. It would be desirable for the bank to be closed and promptly reopened and run under the oversight of the FDIC (presumably using hired managers or contracting with another bank to manage the institution). After an appropriate period, when asset problems have been sorted out, the extent of problems can be accurately gauged, and potential purchasers can make an informed judgment, the FDIC could seek to sell the repositioned bank to another institution or a private investor group. Another option would be for an interested banking organization to make an investment in the bank and manage it for the FDIC under some profit-sharing arrangement with the FDIC. In either case, the objective would be to return the bank to the private sector in an orderly manner.

Present law does not allow the FDIC to operate a full-powered bank even on a transition or bridge basis. Legislation should be enacted so that the FDIC can be empowered to own and operate a bank for a limited period of time in those circumstances which I have described. Such a "bridge bank" would have all the powers that national banks enjoy, as well as certain special protections currently afforded Deposit Insurance National Banks. The "bridge bank" would operate as an entity separate from the FDIC and with a separate board of directors.. The FDIC should be authorized to operate it for a reasonable period of time, consistent with the transitional nature of the institution. These characteristics should allow the FDIC to maintain some franchise value of the failed bank, while arranging for an orderly transfer of assets and avoiding a windfall to shareholders.

A depositor preference statute would also facilitate the handling of a large, failed bank. Such institutions sometimes have considerable nondeposit liabilities, particularly in connection with guaranties, other off-balance-sheet activities and litigation. Depositor preference, the expansion of the Garn-St Germain interstate provision and providing the FDIC with authority to operate a "bridge bank" would materially increase our options for handling large bank failures and, over time, lessen our costs, while contributing to the stability of the system.

Risk-Related Deposit Insurance Premiums

Currently, all FDIC-insured banks pay a premium of 1/12 of one percent of domestic deposits for deposit insurance. The FDIC then deducts its losses and operating expenses and rebates 60 percent of the balance to the banks.

We favor legislation to establish a system of risk-related insurance premiums. Such a system would penalize some risk-taking in the banking system and, at the same time, would be more equitable. A risk-based system would be less arbitrary in that currently all banks -- the best and the worst -- pay the same price for deposit insurance. It would also provide a significant financial incentive for banks to avoid excessive risk-taking and to correct their problems promptly. Perhaps as important, it would send a strong signal to a problem bank's management and board of directors.

Last September, the FDIC requested comment from the banking industry and the general public on a specific risk-based premium proposal. Under that proposal, the FDIC would use objective statistical techniques based solely on Call Report-generated data to rate banks as having either a normal or an above-normal level of risk. Banks would be rated on financial variables (measured as a percent of total assets) like primary capital, loans more than 90 days past due, nonaccruing loans, net chargeoffs, and net income. Those banks rated as having above-normal risk would have been subject to a second testing screen. If a bank were rated as having above-normal risk based on the Call Report test and it had a composite CAMEL rating of 3, 4 or 5, it would have received no assessment credit. The above-normal risk banks which had a composite CAMEL rating of 1 or 2 would not have been denied their assessment credit but would have been subject to additional financial review.

So far, the FDIC has received more than a hundred comment letters addressing this proposal. The majority of them are supportive of the concept of risk-based premiums, although many recommendations were offered for revising the proposed system.

After considering these comment letters and reviewing the initial proposal, we would suggest some modifications. We would still propose that risk be measured first by a test based on Call Report ratios and then by a CAMEL screen which is used only to exempt banks with a 1 or 2 rating from a high risk category indicated by the statistical data. Our tests show this type of use of CAMEL ratings to be very effective in classifying banks. We are continuing research to determine whether a wider range of financial variables would enhance our measurement of risk and the likelihood that an individual bank will become a problem to the FDIC. Since almost all insolvencies stem from credit quality problems, our formula is slanted heavily in that direction. Although other factors, such as liquidity, are important factors in a bank's operations, they often are more difficult to quantify, and incorporating them into formulas has not improved predictive results. Nonetheless, further research in this area may lead to an alternative list of financial variables to be included in any final proposal. As more data become available on off-balance-sheet risk, the incorporation of these data might improve predictive results.

We recognize that our proposed measure of risk classifies banks according to currently observable problems rather than by a system designed to measure risk before credit quality problems arise. The latter approach conceptually would be preferred; however, such measures of risk are difficult to construct and often result in subjective determination of what should be classified as a risky behavior or activity.

We now propose that those banks the system determined to be risky would actually pay a higher premium (up to 2/12 of one percent) rather than just forfeiting their assessment credits. This would assure that riskier banks would pay significantly more even in times when the assessment credit is low or nonexistent. In the future, after the system is more refined, the FDIC may wish to ask for authority to charge even higher premiums to the riskier banks.

We believe two assessment classes are adequate for our initial system. From the beginning, the thinking at the FDIC has been to start simple and then, with experience, work toward a more sophisticated system. In the future, we may wish to fine-tune the system and divide banks into more than two risk classes. At this juncture the FDIC favors legislation that would provide it with broad discretion to implement a risk-based premium system without locking ourselves into specific variables or risk classes.

The current assessment base is deposits in domestic offices of FDIC-insured banks. As already noted, present P&A procedures provide full coverage to nondeposit general creditors who do not pay insurance assessments. If a depositor preference statute is enacted, nondeposit creditors would not have to be covered in a P&A. However, some bank borrowings and other obligations

may be shifted to deposit relationships to upgrade their creditor position. To the extent this occurs, the FDIC assessment base will be broadened and assessment income will be increased.

Most of my comments thus far have been concerned with "failure management" -- how to handle failing and failed banks in a manner that will minimize their cost and their disruptive impact on the economy. I have also discussed improvements in the financing of the deposit insurance system. The FDIC is also concerned with preventing bank failures or at least preventing too many failures and allowing banks to become so insolvent that they become a significant drain on our resources.

Independent Bank Supervisory System

It is critical that we, along with other Federal and state supervisors, maintain high quality supervision and strive to improve that quality. Banking and finance have become more complicated in recent years. Increased competition and a more uncertain environment have made banking more difficult and, apparently, more risky. It is extremely important that bank supervision keep pace with changes in the banking environment.

Deregulation has increased bank options with respect to what products banks can offer, where they choose to offer them and how they price them. It may have increased the potential for conflict of interest between "banks" and their corporate owners. Deregulation does not imply that we can relax supervision. The opposite is closer to the truth. As I have suggested, increased

The CHAIRMAN. Thank you, Mr. Seidman.
Senator D'Amato.

STATEMENT OF SENATOR ALFONSE D'AMATO

Senator D'AMATO. Mr. Chairman, I commend you for holding this hearing. This morning the Banking Committee continues its indepth examination of the adequacy of Federal insurance funds. To date, these hearings have examined the adequacy of depository insurance funds maintained and managed by the Federal Deposit Insurance Corporation [FDIC], the Federal Savings and Loan Insurance Corporation [FSLIC], the Pension Benefit Guaranty Corporation [PBGC] and the Securities Investor Protection Corporation [SIPC]. We have also examined the adequacy of State guaranty funds in the areas of health, life, property, and liability insurance.

Although we have conducted several hearings on the subject of deposit insurance reform, we have yet to find a proposal that would please all of the interested parties or that would not exacerbate the problems already confronted by certain deposit insurance funds. While I think the issue of deposit reform merits the detailed analysis that these hearings provide, I think prudence dictates that we begin to develop some legislative proposals.

It became clear during our hearing Tuesday that the hearings already have prodded the regulators into action. Although I have some reservations about the solutions to deposit insurance reform advocated by Chairmen Seidman and Gray, I am glad that they are offering recommendations about legislative proposals. Their input is crucial because the failure to develop an effective legislative response will cause public confidence in our financial system to erode further.

Although a majority of banks and thrift institutions are in sound financial condition, the loss of confidence in the financial system could detonate a chain reaction throughout the economy. It is our duty to ensure that the proper measures are taken since we are charged with the obligation of maintaining the safety and soundness of our financial system.

This morning I look forward to the testimony of our distinguished witnesses and the proposals they have regarding the reform of the Federal Deposit Insurance System. Since the commencement of this series of hearings we have addressed many alternatives to insure that depositor confidence is not eroded further. I am particularly concerned with the plight of the FSLIC's fund. In view of the fact that nearly 20 percent of the industry is still financially imperiled, it appears that the funds may be grossly inadequate. Therefore, I look forward to working with you, Mr. Chairman, and the witnesses that have appeared before the committee to address the problems facing FSLIC and the other deposit insurance funds.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Seidman, testifying before this committee last week on behalf of the administration, George Gould stated, and I quote:

> The Deposit Insurance System can only be as strong as the industry it stands behind. We are urging Congress to permit the depository institutions to evolve in their marketplace.

Do you agree with this statement and the implicit urgency on Congress to act to bring today's banking laws more in line with the remarkable changes that are going on in the marketplace?

Mr. Seidman. I certainly agree with that; yes, sir.

The Chairman. Mr. Gray, I assume you would, as well.

Mr. Gray. Yes.

NONBANK BANK LOOPHOLE

The Chairman. During the same hearing Mr. Gould argued against closing the nonbank bank loophole. He said,

> I cannot see anything wrong with a bank which orients its business toward consumers. Indeed, it brings additional capital skills, competition and perhaps retail expertise into the banking system.

What is your position on the nonbank bank loophole?

Mr. Seidman. Mr. Chairman, my view is that a bank is a bank is a bank. We ought to have one definition of banks and all banks ought to operate on a level playing field. I therefore feel that if the rules for nonbank banks are going to be more lenient for banks, then everyone should operate under those rules. In the alternative, the nonbanks should be brought under the regulations to which real banks are now subject—to the same regulations to which real banks are now subject.

The Chairman. Mr. Gray.

Mr. Gray. Mr. Chairman, we have never taken a position on the merits or demerits of nonbank banks. We have always discussed nonbank banks in the context of our needs at the FSLIC. I recall 1½ years ago or so, there was a substantial interest in a particular thrift institution by a large bank holding company. But after the Comptroller opened up the loophole, that source of possible acquisition and savings to the FSLIC dried up. So we are continuing to stress, in our own view, the need for closing the nonbank bank loophole, because it has created what we think is a significant impairment to our ability to resolve cases throughout the marketplace.

The Chairman. I would assume that both of you would probably agree that whatever the merits of Gould's statement of its effects on consumers and the benefits of nonbank banks, that the original definition of banks, probably no one foresaw what would occur. It was probably an accident. Certainly not by design. And we certainly should, as you say, at least define it, so that we are treating each other or each segment equally.

Mr. Seidman. I certainly agree with that, Mr. Chairman. I think the evidence is quite clear that no one foresaw this was going to develop a whole new industry of nonbank banks.

The Chairman. Of course, no one foresaw the incredible change in the marketplace either. That is why it is so hard for me after all these years, to have particularly the House or some of my colleagues in the Senate, who cannot see what is taking place out there, our laws were not designed to fit the current marketplace. Well-intended at the time they were passed, certainly needed at the time they were passed, but not fitting the situation today.

You start comparing the marketplace of today with even 5 years ago and the changes are dramatic. When we go back and look at when Glass-Steagall was passed and McFadden, the basic laws on the financial services industry, it is like two completely different worlds. There is no relationship whatsoever. Yet we still have people insisting that we should have no comprehensive legislation. I don't even understand that, and that is not arguing for any particular provisions or powers or anything else. That is just the general premise that the marketplace has changed, and are we going to sit down and look at fundamental changes in the law to match those changes in the marketplace.

Mr. Seidman, on page 3, you say: "I do not believe the system is in need of fundamental change that would impose greater risk on depositors or substantially increase capital requirements of banks."

CAPITAL REQUIREMENTS FOR BANKS

Do you believe it is now necessary to raise capital 100 percent?

Mr. SEIDMAN. I have looked at that question, and it is not one that I think one can answer with absolute certainty. I have spent some time with our people trying to find evidence to support the fact that we need to move capital to 9 percent. At this point, I have not found the kind of empirical evidence that convinces me that we ought to move in that direction at this time.

So I do not favor that at this time, although I think it is a subject which we need to continue to study, and when we move, we ought to move very carefully.

The CHAIRMAN. Mr. Gray, again referring to George Gould's testimony, he said last week, and I am quoting

> Some proposals before the Congress, such as the tandem restrictions, make thrift acquisitions exceedingly unattractive. They also strike a blow against consumers by prohibiting cross marketing and other business connections and improving service and competition.

You state you have problems with the in tandem language in H.R. 20. I interpret your statement to say you nonetheless support some restrictions on these activities. Tandem operations certainly do seem to be a staple of American business, but what evidence can you cite to support your position that there is no problem with tandem sales?

Mr. GRAY. I am not saying that there are no problems with some aspects of tandem operations. What we are basically saying is that the Bank Board has the expertise and the ability itself to determine how tandem operations are applied in various cases, and we have continued to do that over a period of time. I would say that in the case, for example, of a bank holding company seeking to acquire a failing thrift institution, the Federal Reserve Board, of course, in its capacity, can impose certain restrictions. We believe, as I have indicated in our testimony, that perhaps the Bank Board, itself, when a bank holding company wishes to acquire one of these institutions, should have the sole authority to determine what kind of tandem operations should be allowed rather than to have that authority, in effect, taken out of our hands.

The CHAIRMAN. Mr. Gould also urged Congress and regulators to look twice before determining in certain classes of bidders, such as securities firms, cannot be accommodated in some fashion.

As an example, acquisition of a failing thrift. This statement, I suppose, seems to be directed at you and the Federal Home Loan Bank Board. You have opposed the purchase of thrifts by any company that engaged in securities operations.

Has your position changed in any regard?

Mr. GRAY. Our position dates back to the fall of 1983, Mr. Chairman, when there was a good deal of discussion about whether affiliations of thrifts and those kinds of entities which engage in securities underwriting and marketing, should be able to acquire thrifts. I have believed, and this is shared by the Board, that this is such an important issue going back to the long history of Glass-Steagall, that the Congress itself should make a determination on this matter rather than the regulators. And I am willing, of course, to live with whatever decision the Congress makes. But I think that the policy implications of affiliating securities underwriters with thrifts, given the long history that has been in place, means that so far as we are concerned, this kind of decision is so big that the real determinant of public policy—that is to say, the Congress itself—ought to make that decision.

RESTRICTIONS ON BRANCHING

The CHAIRMAN. Mr. Seidman, you state that you are not inclined to amend the financial statutes to accommodate purchase and assumption transactions [P&A] acquisitions of failed institutions. You suggest the FDIC should be allowed to charge banks in that State a higher insurance assessment.

Have you got any idea how much in additional assessments you are talking about?

Mr. SEIDMAN. The first part of my premise is, Mr. Chairman, that the insurance fund ought to have the right to charge higher premiums to those institutions that are increasing the risk to the fund and costing it more money.

In terms of the States, that would only apply where they did not allow branching of a failing institution. That wouldn't mean branching throughout the State on a generalized basis.

We haven't had yet a chance to come up with a number on that, although we do see that out of the some 35 payoffs we have had in the last year, 30 of them came in States that did have restrictions.

I can also report to you that a substantial number of those States are now looking at changing their laws to allow branching for failing institutions.

The CHAIRMAN. According to your testimony, most payouts have occurred when there have been no institutions interested in acquiring a failed bank.

From the failures in 1985, can you give me an estimate of what percentage were handled by liquidation versus P&A?

Mr. SEIDMAN. We had about 22 payoffs out of 120 failures in system transactions.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman. Let me welcome our two witnesses today.

As is always the case when you get the Commerce Committee and other committees at work at the same time, we have to move back and forth between committees.

Chairman Seidman, let me ask you initially here. You start out in your statement by indicating the number of banks that are on the FDIC's problem list, and you indicate that the number has been increasing steadily since the spring of 1981.

RISING BANK FAILURES

We have gone from a number at that time in 1981 of 200 banks up to a total of 1,196 banks on the problem list as of March 3. Then you talk a little bit about why that seems to be happening.

Now that you have had a chance to sort of get your hands around this problem and try to sort out some of the regional problems which I know are a factor and some of the sectoral problems, can you give me a little better sense as to the texture of the problem of banks that are on the troubled list?

Are they going to keep growing, or are we likely to see those totals continue to rise, sort of inescapably here? What more can you tell us about the nature of that set of problems?

Mr. SEIDMAN. I think it is unlikely we will go back to the days when we only had 100 or 200 banks on the problem list. Whether it is going to rise more or not depends on a number of factors which I would like to discuss with you.

I think, first, banking has been deregulated to some extent. It has also been made much more competitive through nonbank banks, foreign banks, and other things.

So banking is just fundamentally a more competitive business and a business which requires better and more intense management than it did when it was a totally regulated or a much more regulated industry. As a result of there being more constraints on management, when we had economic conditions which also impinge on that competitive situation, such as we have in agriculture at the moment, then managements begin to become subject to the real test of whether they can handle difficulty.

Since managements in banking, I suppose, are no different from any other managements—some are very good and some are quite poor and most are in the middle of the curve—as things get tougher you start to move up the curve and more institutions are unable to handle the situation.

So as we look at the situation, it is a combination of problems in the economy right now—40 percent of the banks on our list are agricultural banks—and the general nature of the change in the banking system.

Let me add, I think that the competitive factors mean those banks that are operating well—and that is the great majority of banks—have stronger and better managements because of the changes that have been taking place in the system.

So I think that overall the system has improved, even though we are seeing those at the fringe getting into trouble.

Senator RIEGLE. Does the prospect of lower interest rates, which of course have now occurred—but if they continue, is that a major factor, in your view, in helping to solve this problem, or is this problem going to persist regardless of where interest rates happen to be?

Mr. SEIDMAN. I think lower interest rates are going to help. They are particularly going to help our savings banks, which is a major area of the problem, and lower interest rates generally should help the economy, and that should help all of our banks.

So in general that is a favorable aspect at the moment.

Senator RIEGLE. I am going to ask one other question. Then I would like to turn to Chairman Gray.

SOUTHWEST REGIONAL PROBLEM

That is, when you look at the regional problem in the Southwest, which we are beginning to know more about—because you have the overlap of the oil and gas problems and the agricultural problems and some commercial real estate problems and maybe others that I am not familiar with—but are you finding that this combination of factors are doing particular damage or are particularly destabilizing to banks in that part of the country? Is that a particularly serious problem as you see it now?

Mr. SEIDMAN. Where you find banks which have substantial percentage of their portfolio in troubled areas, as some banks do in that area, it certainly makes it more difficult for them. You are likely to find many more of them on our problem list, yes.

Senator RIEGLE. Would the largest number of the most extreme problems at the moment be centered in that part of the country or not?

Mr. SEIDMAN. Well, the largest percentage now are agricultural banks. That goes down through mid-America, through the Farm Belt, then down into Oklahoma and Texas. Those are the places of greatest concentration.

Senator RIEGLE. Do we have any of the top 20 banks on the problem list, or did that put Continental Illinois in a special category?

Mr. SEIDMAN. There are large banks on the problem list.

Senator RIEGLE. Can you indicate how many?

Mr. SEIDMAN. I don't think I could right now. I don't have that information right in mind, but I have some doubt as to whether we ought to disclose that at this moment.

Senator RIEGLE. I am not going to press for that, but I gather, then, that while the agricultural loan problem is one significant component of the problem, it also ranges up and includes some of the big banks in the country as well in the top 20 that are also experiencing difficulty.

Mr. SEIDMAN. Well, there are a number of banks that are involved in agriculture, large banks. There are large banks in the international area. So there are both large and small banks that have problems.

VITAL NEED FOR S&L'S

Senator RIEGLE. Chairman Gray, in your prepared statement on page 23 you say that the Bush task force on regulation of financial services—and you quote them:

> Unanimously agreed that savings institutions are indeed different from commercial banks and that a separate thrift industry is a vital force in the Nation's housing finance system.

It sounds like maybe you did a little homework to get that in there, but in any event, that is in the Bush task force report.

On the other hand, in the 1986 economic report of the President, we see statements that seem to directly challenge the need for a separate entity that is designed for housing finance.

In a section on thrifts in the economic report of the President, the report says—and I want to quote it:

> It may be appropriate to reconsider the wisdom of designating limited purpose lenders, including mortgage lenders. Commercial banks have been very active in mortgage lending, and their activity plus the success of firms in the secondary market for mortgages makes clear that mortgage lending does not require a separate subsidized financial sector.

It sounds to me like these two policy statements are really at odds with one another, and I am just wondering, do you see any inconsistency between those statements? And I am wondering, is the administration committed to preserving a separate specialized thrift industry to serve the housing financing needs of the country?

Mr. GRAY. Senator, I recognize that the Economic Report of the President, which was prepared by the Council of Economic Advisers, does make the statement you have read. I am not sure that I can characterize a position for the administration as a whole, given the fact that the administration is somewhat amorphous; that is to say, it has a number of entities which are component parts.

But the idea that we somehow do not need specialized institutions, such as thrifts, in our society has been around for some time. It is certainly not novel.

Let me just point out that in 1985 savings institutions made 55 percent of the mortgage originations accomplished in our country, and that has been roughly the same since the 1960's. I would point out that the commercial banks, by comparison, generally speaking, make only about 15 percent of the mortgage originations. Thrift institutions hold close to 70 percent of their assets in mortgages, mortgage-backed securities, and CMO's.

So there is, in my view, a very definite need for continuation of a separate and integral thrift system; The Bush task force unanimously recommended that we ought to have a separate and integral thrift system. The task force of which I was a member did suggest in its report that thrifts ought to remain principally involved in housing finance, as these figures indicate.

But I obviously strongly disagree with the idea that we do not need a separate and integral thrift system as we have now. I think all the figures that I have referred to stress the importance of continuing the thrift system to enhance home ownership opportunities.

Senator RIEGLE. Thank you. My time is up. I have some more questions.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

HIGHER PREMIUMS FOR RISK-RELATED BANKS

Mr. Seidman, on your remarks you mentioned insurance reform, that some banks would pay twice what other institutions might have to pay.

In my opinion, when this word would get out, wouldn't that trigger problems rather than solve them?

Mr. SEIDMAN. Senator, I think that the effect of charging banks higher premiums if they take higher risks should be that those banks will reconsider the path that they have been following. That information will go to the directors of the bank, and they will note that the bank is operating in a high-risk manner.

So my hope is that as a result of being charged more, that they will steer a course that will be less risky.

Senator HECHT. What about setting certain minimum standards of lending, and it is up to the banks to determine, by meeting those standards, how conservative or how liberal they want to be?

But this is a management problem; wouldn't you say so?

Mr. SEIDMAN. It is a management decision, and we are trying to make a similar type of management decision as an operator of an insurance fund. If we were in the private sector, we would clearly charge higher premiums to those institutions which were presenting a greater risk to the fund.

So we are simply saying to them, if you want to operate at a higher risk, that in the end is going to cost the fund more, therefore you ought to pay for it and not ask others to pay for it when they are operating at an average risk.

Senator HECHT. What guidelines would you set down?

Mr. SEIDMAN. That is a very difficult question. We have a number of statistical tests which we have put together and which we have sent out to the banking industry for comment, which indicate that if a bank has a certain loss of capital relationship of their classified loans to their capital under such tests, that when these tests with certain guidelines are exceeded the bank is more likely to be a candidate for failure.

So we have statistical tests which we are still working on, but are designed to indicate those banks which are operating in a riskier manner.

Senator HECHT. Basically, you have those powers to go into a bank today when their delinquent loans are at such a figure and tell them they have got to change?

Mr. SEIDMAN. We have the power if they are operating in an unsafe manner. What we are trying to do now is simply deal with those who are operating in a higher risk manner and are more likely to be a cost to the fund. It is an additional way to try to put some kind of discipline into the system to reduce risk.

Senator HECHT. But traditionally, Western bankers have taken more chances than Eastern bankers. So I just find you are getting to the management position too much.

Mr. SEIDMAN. Right now there are more Western banks on our problem list than Eastern banks, and it is a good question as to whether Eastern banks should pay the additional costs of Western banks which want to have a higher risk operation and will show higher failure rates.

Senator HECHT. Well, leading to the next question, the Third World debt and particularly the problems in Mexico of lower oil prices, which center more in the Eastern banks than the Western banks, how do you feel about this bombshell?

Mr. SEIDMAN. I think all the considerations that are given in any area should be the same. We would look at classifying loans in that area in the same way they classify it in other areas.

I don't think there is any reason to have a different standard in a different part of the country or for different kinds of loans.

Senator HECHT. How serious do you think the Third World problem is on debt?

Mr. SEIDMAN. There are some serious problems in Third World debt, particularly with regard to those countries that depend upon oil as a principal export. Those problems will have to be met, and one can only say that they have been met in the past. We feel confident they are going to be met now.

Senator HECHT. So it is not really a major concern, as has been written up in many newspapers, to you?

Mr. SEIDMAN. I think it is a serious problem.

Senator HECHT. Are you taking any contingent actions on this?

Mr. SEIDMAN. We are working on it with the other regulators, and we are well aware that it is a serious problem, and we are working with the Treasury and the other regulators to handle it.

Senator HECHT. What type of policies, what type of actions are you doing? You say you are working on it.

INITIATIVES TO HELP RESTRUCTURE THIRD WORLD LOANS

Mr. SEIDMAN. We are looking at their financial positions with the Treasury and attempting to find plans. Part of it is the Baker initiative, which Secretary Baker put out some months ago, which is an effort to help those countries improve their economies so that they will be better able to handle their debts, and that certainly is underway at the moment.

Other initiatives include restructuring of loans and things of that nature.

Senator HECHT. I will shift over. As the marketplace continues to expand, either with or without the assistance of Congress, and you at the FDIC move to meet these new challenges, how are you going to assure equitable treatment of small and large commercial banks?

By that, certain banks in Oklahoma, their depositors over $100,000 did not get the money, and Continental, they were paid 100 percent.

How do you rationalize that, or are you in the future?

Mr. SEIDMAN. I think it is a weakness in the System that has to be corrected. We have proposed today that we be given additional powers.

In almost all cases we will be able to treat all depositors in the same way that the Continental Illinois depositors were treated.

At some point we may develop a system where a very large bank can be handled on a modified payout basis, where all depositors will not be fully reimbursed. When that day comes, then we can treat small banks in the same way.

competition among banks and between banks and other institutions (including nonbank banks) has placed strains on bank earnings and, possibly, encouraged risk taking. At this time, when demands on supervision are increasing, it is critical that we train and expand a quality staff to examine and supervise banks so that current and potential future problems are controlled. Otherwise, the cost to the FDIC and the economy will soar. It is particularly important that neither Gramm-Rudman-Hollings nor OMB apportionment prevent the buildup of a capable supervisory staff in the Federal bank regulatory agencies nor limit the independence and flexibility of bank regulatory agencies.

We need Federal legislation ensuring that adequate independent bank supervision is provided by responsible agencies. We are convinced that bank supervision must play an even larger role in monitoring risk and reducing the exposure of the deposit insurance system and our economy to unnecessary risk. Supervision must be increased as deregulation provides bankers with the needed opportunity to use their judgment in making business decisions. For the first time in over fifty years, the Office of Management and Budget has asserted new jurisdiction over three of the four regulatory agencies, attempting to overturn a half century of independent operations. The Congress should act swiftly to maintain the competence and flexibility of the regulatory agencies. Otherwise, the operation of the Comptroller, the Bank Board and the FDIC will be adversely affected to a significant degree.

Supervision is not the only way to prevent excessive risk in the system. There

has been much discussion during the past two years about various kinds of market discipline. I have indicated that, at this time, we don't know a way to use increased depositor discipline to improve the system. However, market discipline can come in many ways. The relatively high failure rate of the past few years has imposed losses on bank stockholders and subordinated creditors and job loss to bank managers; it has not been an altogether painless process. If depositor preference is enacted, an additional class of bank creditor will be exposed to loss. Risk-based insurance premiums will impose higher costs on those banks operating at higher risk. Capital requirements which have been raised in recent years impose a cost and discipline on the system. They would be raised again if additional capital requirements are found necessary as we examine a risk-based capital requirement. To the extent that future conditions warrant higher capital requirements, that presents a further opportunity to enhance market discipline.

Financial Condition of the FDIC

The FDIC's insurance fund is adequate to handle the problems of the day and those likely to be faced in the near future. The FDIC's Deposit Insurance Fund, its net worth, currently is about $18 billion, and its assets include about $16 billion of U.S. Treasury securities. The size of the fund relative to insured and total deposit liabilities of banks remains high by historical standards. The fund is currently 1.22 percent of insured deposits, well above the average for the past 10 years, despite record numbers of insured bank failures during the past two years. The fund's growth during the last two years has slowed as a result of losses and reserves established in connection with bank failures. These losses have resulted in insured banks receiving only small assessment rebates for 1983 and 1984 operations. They will receive no rebate for 1985, although, to a large extent, this reflects higher loss estimates in failures occurring prior to 1985.

Last week, the FDIC added $2.3 billion to its allowance for insurance losses. However, only $600 million related to the 1985 failures. $1.3 billion related to the 1984 assistance transaction with Continental Illinois Corporation. While that transaction still has several years to run, our loss reserve reflects our assessment of likely ultimate loss on loans that have or might be put to the FDIC exclusive of potential future gains or losses on our stock investment in Continental. It is important to emphasize that we have attempted to conservatively account for all projected losses and commitments related to failures and assistance transactions. This includes estimates of our ultimate losses on assets acquired in connection with all failures as well as losses related to commitments in connection with assisted mergers. We have also established reserves for those savings banks with outstanding net worth certificates where the FDIC seems likely to incur a loss.

While we believe the Deposit Insurance Fund and the basic assessment rate for satisfactorily performing banks are adequate at present, the assessment system and the long-run strength of the fund would be materially enhanced by enactment of our recommendations on risk-based insurance assessments and depositor preference.

I believe that the FDIC's balance sheet conservatively reflects our exposure

from past bank failures. It is more difficult to be absolutely certain about the adequacy of our reserves for meeting future failures. Nevertheless, past experience suggests that current reserves are adequate.

While our fund is coping with today's rapidly changing and difficult conditions in the banking field, we urge swift action to help the insurance system to be better prepared for future challenges.

But until that day is here, we believe that we should attempt to treat depositors in small banks the same way we have historically treated depositors in large banks.

Senator HECHT. Thank you.

Mr. Gray, you mentioned in your statement how you want some changes, regulatory and statutory changes.

What type of statutory changes?

Mr. GRAY. Well, there are a number of statutory changes. There are several that come to mind in particular.

There is a need, I believe, for the Bank Board and the FSLIC to move more quickly—and the changes we are discussing we believe will help us to move more quickly—into those institutions that are failing or are moving very directly toward an insolvent position.

For example, we believe that the Bank Board should be given explicit statutory authority to define what constitutes an unsafe and unsound practice pursuant to the National Housing Act.

We also believe that the term "substantial" as a modifier for "dissipation of assets" should be removed from the statute. In that way we would have less difficulty when we seek temporary cease-and-desist orders.

At present, we have a very short period of time to determine what constitutes "substantial dissipation of assets." It is very difficult to defend in court with the limited time we have that they are in fact substantial because that term really has no definition.

We believe that we ought to have the authority, when there is a dissipation of assets which leads us to believe that there are going to be serious problems, to move quicker and therefore prevent additional losses, which ultimately the FSLIC is going to have to pick up.

We have limited and finite resources, and we believe that these are ways in which we could protect the reserves of the FSLIC, which is our statutory responsibility.

Senator HECHT. When will you be coming back to us with these changes?

Mr. GRAY. We have sent legislation to the House and Senate Banking Committees for the last 2 years. I believe essentially we have already proposed these changes.

We intend to send up a new legislative package, which will include these, and that will involve some refinements.

Senator HECHT. My time is up. I am going to study both of your statements. I would like to reserve the opportunity to talk to you later after I have studied them.

Thank you.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Thank you, Senator Garn.

I would like to submit some written questions, and I have a statement.

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I am pleased to be here this morning as the Banking Committee continues its hearings into deposit insurance reform and related supervisory issues. I look forward to hearing from the distinguished Chairman of the Federal Deposit Insurance

Corporation, and the distinguished Chairman of the Federal Home Loan Bank Board.

The questions surrounding deposit insurance reform in the banking and thrift industries are among the toughest facing the committee this year. For the banking industry, we need to resolve tough problems related to how the FDIC handles small bank failures as opposed to large bank problems. There are major questions as to how foreign deposits, which are not insured, but which effectively receive insurance coverage, should be treated. There are serious concerns about the risk-related premium issue—what would such a system look like and how effective would it be in increasing discipline on banks and minimizing the risk to the FDIC fund.

There are even more serious issues facing the FSLIC insurance fund. The most important of these is how to increase the resources of the fund to handle current and expected future industry problems. The thrift industry improved its position last year, but the condition of the FSLIC insurance fund continued to deteriorate. One of our top priorities this year must be to address this issue.

I have only touched on a few of the difficult and contentious issues facing the two Chairmen and this committee. I appreciate the opportunity to have their analysis of the issues, and their recommendations for change.

Thank you, Mr. Chairman.

GAO REPORT ON THE THRIFT INDUSTRY

The CHAIRMAN. Mr. Gray, before the House Banking Committee on Financial Institutions last week, a GAO official said the prognosis is poor for the Nation's 461 insolvent thrifts, despite record-breaking profits. Moreover, the official said losses of insolvent thrifts will be even higher than previously estimated.

Do you agree with that statement?

Mr. GRAY. We believe the GAO report, when it came out, was somewhat out of date because of the high profitability of the industry in 1985.

I have already suggested that we believe the industry can enjoy a repeat of that profitability in 1986. But our analysis of the numbers in the GAO report indicates that less than 8 percent of the industry should be considered potential problem cases for the FSLIC.

And when I say that, I mean about 8 percent would probably require assistance.

We believe that the GAO report for this reason was flawed, because it dramatically overstated the magnitude of the problem.

I want to hasten to say, Mr. Chairman, that this does not mean that we don't recognize there is a very significant problem. It is merely that the problem is overstated in the GAO report.

The CHAIRMAN. We have talked to both of you this morning about troubled institutions. I always feel it is necessary in these hearings to clarify that, but a lot of people assume that an institution, either a savings and loan or a bank, on the trouble list is about to fail, and they view the trouble list as a failing list.

I would like to emphasize—and I am sure I would have your concurrence—that because a thrift or a bank is on the trouble list that does not necessarily indicate that they are failing now or will fail in the future. The primary use of a troubled institution list is so that you flag them for additional attention, and the full reason for that is to prevent them from failing.

Is that correct?

Mr. SEIDMAN. That is correct, sir.

About 10 percent of the number on the problem list will actually fail.

The CHAIRMAN. I want to emphasize this because we often hold these hearings and people leave thinking we have got *x* number hundred of institutions that will fail. Most of them don't, as you have said. Only about 10 percent will; 90 percent do not, and the very reason we put them on the troubled list is to give them aid and help and follow that progress so that you can get them back off the troubled list.

In a speech on March 6 before the California League of Savings Institutions, Fed Governor Martha Seger recommended that the bank holding companies be allowed to acquire thrifts and thrifts be allowed to acquire banks.

She said, and I quote: "If thrift institutions are going to have full commercial banking powers, they should be eligible for acquisition by bank holding companies."

She added that such cross-industry acquisitions should be allowed, "without consideration for the financial health of the firm to be acquired."

Do you agree with Martha Seger's statement?

Mr. GRAY. Let me try to answer that first. I, of course, would take a different approach, given the fact that I am the CEO of the FSLIC.

In its wisdom, the Garn-St Germain Act provided the means by which the FSLIC could ameliorate its challenges by in effect providing new franchise rights, State operating rights, for those banks and other entities wishing to acquire a failed thrift.

If we don't keep that carrot there, it will be much more difficult for us to deal with our FSLIC problem over time. So until we have the resources to deal with our difficulties, given the reserves at the FSLIC, I do believe that the major thrust ought to be for bank holding companies and other entities to have the sufficient rewards and incentives to acquire failed thrifts.

DEPOSITOR PREFERENCE STATUTE

The CHAIRMAN. Mr. Seidman, could you explain for the committee how a Federal depositor preference statute would operate? Would it guarantee protection only to those insured depositors at less than $100,000?

Mr. SEIDMAN. No. The depositor insurance preference statute would simply say that those depositors that were not insured over $100,000 would be preferred in any transaction following failure. They would come ahead of all other creditors and all other interests of the bank.

The effect of that would be that they would be much more likely to receive the entire amount of their deposit.

The Chairman. You say the principal impediment to doing P&A's is the restrictive branching statute because they limit the potential bidders for failed banks.

Are you advocating amending McFadden to allow a purchaser of a failed institution greater branching privileges than those of the existing banks in the area?

Mr. Seidman. Primarily, what we are advocating is branching within the State—States that will not allow branching with the State might allow it if the institution is failing for that institution. In other words, they would allow the failing institution to be acquired as a branch by any bank in the State.

The Chairman. Regarding the asset test for interstate rescue mergers for failed institutions, George Gould made the following observations, and I quote:

"The same law permits interstate banks to acquire thrifts of any size. The FDIC should not be hamstrung in this fashion."

Why do you request only 50 percent reduction in the assets test rather than elimination of it?

Mr. Seidman. Everything in moderation, I guess, Senator.

We would not object to eliminating it.

The Chairman. Can I make sure that I understand exactly what your recommendation is regarding the emergency acquisition provisions of Garn-St Germain?

You want to, No. 1, include failing banks in addition to failed banks?

Mr. Seidman. Yes.

The Chairman. No. 2, allow the purchase by bankholding companies of failed or failing banks, and, No. 3, lower the asset requirements from $500 to $250 million.

While the request is probably a reasonable one, if you couldn't get any of the above, would you at a minimum recommend extending the existing expiring provisions before April 15?

Mr. Seidman. Very definitely.

The Chairman. Since Congress has authorized regional banking, not nationwide interstate banking—or I should say the courts. We authorized it in the Senate. It never became so in the House—Congress has allowed that.

Should banks in a regional compact be given the first right to purchase failed or failing institutions in that region?

Mr. Seidman. I haven't given that a lot of thought, Senator.

My own feeling is that any bank, in or out, should be equally entitled to purchase the institution that has failed, and it ought to be done on a competitive bidding basis.

Mr. Gray. I would agree.

The Chairman. Well, it is obvious from your statements, Mr. Seidman, that the FDIC continues to favor risk-related insurance premium policies. You have changed the recommended manner in which the risk premium would be levied, charging an additional one-twelfth of 1 percent assessment rather than withholding the assessment of credit.

Could you explain that change and the rationale behind making that change?

Mr. Seidman. Two reasons really for suggesting that change, Senator.

One is that at the present time we are not making any rebate because fund expenses have exceeded its income, and therefore if we put the system in at the present time it wouldn't in fact have any effect.

Second, while I believe the fund is sound, some additional buildup in reserves might well be necessary, looking at the constraints in the system.

The CHAIRMAN. Under your recommended system of risk-based assessments, would deposits in foreign branches be included or excluded in the assessment base?

Mr. SEIDMAN. That depends to some extent on how we finally are able to decide the question of whether we are going to handle all depositors in the way we have been handling depositors in large banks; in other words, protecting all depositors.

If they are all protected, then I think it is a very strong argument for including the foreign deposits. The banks with foreign deposits have made the argument that this will hurt them competitively.

I haven't weighed that fully, and I would want to look at that, but my feeling is that once you are in fact taking care of all depositors on at least a de facto insured basis, it is very difficult not to include foreign deposits.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Gray, I am now going to give you a chance to respond to the question that I asked at the beginning in my own remarks.

I am not going to repeat the quotation, but the President's Council on Economic Advisers, having expressed the position of the administration, it said that commercial banks have been very active in mortgage lending but the success of firms in the secondary market for mortgages makes clear that mortgage lending does not require a separate subsidized financial sector.

That could easily be interpreted—I don't know you interpret it any other way—that we don't need savings and loans; we don't need your excellent regulatory activity.

What is your response to that?

Mr. GRAY. First, I'm not sure in my own mind that that represents the policy of the administration in that it was, and always is, written by the Council of Economic Advisers. I'm not sure how far that extends within the administration.

For example, we have been working very closely with senior Treasury staff on a means by which we could recapitalize the FSLIC fund. I suppose I could say that if the administration were moving in this direction, then it would be somewhat contradictory that we are making these joint efforts to try to deal with the FSLIC problems through recapitalization.

THRIFTS MADE 55 PERCENT OF NATION'S MORTGAGES

Let me go a little further though and say what I said a little earlier, when you were gone, Senator, that savings institutions in 1985 made 55 percent of the Nation's mortgage originations. That has been roughly the same since the late 1960's.

I would point by comparison to commercial banking activities in this regard. Only 15 percent of mortgage originations are, generally speaking, made by commercial banks.

Second, thrift institutions hold close to 70 percent of their assets in mortgages, mortgage-backed securities and CMO's. This is not a novel idea that somehow we don't need thrift institutions.

I believe that if the thrift system were to be dismantled there would be a very real vacuum in our effort as part of national policy to enhance home ownership opportunities for the American people.

I think the record of thrift institutions, and that is a record which continues today and I expect to continue in the future, is that they are principally involved in housing and finance, making mortgages, and that they will continue to be. That is what they know best. And all of our evidence indicates that.

Finally, let me say that the approaches we have taken, as described in our statement, would continue to emphasize mortgage finance because any risk-based capital approach to this problem would provide strong incentives for housing investment, provided that these investments are matched in terms of assets, liability-match and duration match.

Senator **Proxmire**. Thank you very much.

Some people would support phasing out the savings and loan industry including I suppose—Beryl Sprinkel, the Chairman of the Council of Economic Advisers, who wrote this report. But it seems to me to be a serious mistake, and I earnestly hope the administration doesn't take this position.

I agree with you wholeheartedly. Savings and loans provide an absolutely vital function. We've tried for a long, long time to establish institutions that would encourage home ownership. This has done so.

And I'm delighted to hear your position, and I hope you persist in it.

Now, you presented some interesting figures on the growth of the S&L industry in 1984, when S&L's increased their liabilities at the rate of over 19 percent.

However, within the industry, the fastest growers were the weakest in net worth. Those with a regulatory net worth of less than 1 percent grew at a 21-percent rate.

Those with a net worth between 1 and 3 percent grew at a 26-percent rate.

On the other hand, those with a net worth of more than 5 percent grew at a rate of only 15 percent.

I suspect that a lot of the trouble that FSLIC faces today is due to the extremely high rates of growth in 1983 and 1984 on the part of the weakest institutions in the industry; with all that new money coming in so fast there just weren't enough sound investment opportunities.

Of course, it's easy to second-guess with the benefit of hindsight. Nonetheless, I can't help wondering where the Bank Board was during this period.

How is it possible that the Board stood by and permitted this imprudent growth to continue for so long?

Mr. **Gray**. Let me start back about the beginning of my tenure. About 4 months after I became Chairman we began working very closely with the FDIC and jointly, we proposed a regulation which would slow down that kind of growth rate.

That was, of course, the broker deposit regulation, which the Federal judiciary decided later was inappropriate because we had exceeded our statutory authority.

But that was a real attempt at the time to slow down that growth because it was primarily being fueled by instantaneous access to brokered funds.

In February 1984, the Bank Board proposed a net worth regulation that was somewhat similar to the one we ultimately proposed, which was adopted early in 1985. At the time, Senator, there was a mentality where the answer to all of our problems in the thrift industry was to grow out of it through this rapid growth that we saw in 1983, and particularly in 1984.

When we proposed the net worth regulation, the industry virtually unanimously came down very, very hard on us. We looked at it again. We also proposed a direct investment regulation because we were having problems with excessive use of direct investments, and misclassifying direct investments as loans. And we proposed that regulation in the spring 1985.

We had a similar response to this regulation, even though I went around this country and appeared before congressional committees repeatedly to warn that this was happening.

Then, with all of that opposition and with our continued emphasis on the fact that this problem was occurring and that our spread problems of the early eighties were changing into a massive bad asset problem, we hunkered down, as I said.

And I have to say that, because we knew there would be tremendous opposition by many in the industry to what we were doing in connection with the net worth/growth regulation and the direct investment regulation.

ADOPTED TOUGHER REGULATIONS IN 1985

We adopted them in early 1985. And they have had a tremendous impact on slowing down the rate of growth.

Senator PROXMIRE. I appreciate that. But if you'd cracked down harder and sooner, you would have saved a lot of money.

Mr. GRAY. Well, let me say this. The thrift regulatory apparatus was not devised for the kind of deregulation which was occurring in 1983 and 1984. You'll recall that the implementation of the provisions of the Garn-St Germain Act actually went into effect in April 1983.

We recognized that there was a problem. However, we had great difficulty in monitoring the industry because we were so severely limited as to the number of examiners that we could employ.

We were limited by the number of people we had at the FSLIC. We have made progress in that regard. Hindsight always serves to show what we might have done to win the game, or to do better.

But I think the Bank Board recognized the problem. We warned about this problem over and over again. And we did take the actions that we were able to take, with limited staff at the Bank Board.

Senator PROXMIRE. I realize you've got serious limitations and, of course, the pressures are constantly the other way from the industry itself and other people that you see and work with.

But I just feel that in retrospect, and as I say, hindsight is easy, but if you cracked down harder and quicker, it might have been better.

Let me ask you, Mr. Seidman, your predecessor recommended a 9-percent capital standard for commercial banks of which 3 percent would be in the form of subordinated debt.

As I read your testimony, I gather that you believe the present standard is about right, only 6 percent.

Why the change in the FDIC position on capital? Why is more capital suddenly no longer important?

Mr. SEIDMAN. I have two reasons for not subscribing at this time to that proposal. The first was that I tried to find what the imperical evidence was on the need to move from 6 to 9 percent, and on what basis we could make that judgment.

And I haven't yet been able to find the kind of evidence that indicates that that is a necessary step, although we are still studying that and it could be that a move up at some point will be indicated.

Second, there was some part of the former chairman's testimony which in effect said: We need to get more discipline in the System.

And we can get more discipline in the System if we require more capital. Therefore, we will require more capital to get more discipline in the System, by having all the banks go to the marketplace to increase their capital.

It seemed to me that we should not require more capital for the purpose of getting discipline in the System. We should require more capital if in fact more capital was needed.

Senator PROXMIRE. Thank you, Mr. Chairman. My time is up. I would just urge you to go back to that 9 percent.

Safety and soundness is a major fundamental responsibility for you and for us in the Congress.

The CHAIRMAN. Senator Riegle.

CHAIRMEN OF FSLIC AND FDIC ARE TO BE COMMENDED

Senator RIEGLE. Thank you, Mr. Chairman. Just to follow on one point that Senator Proxmire made here with respect to efforts made within the FSLIC to deal with problems that have been building up over a long period of time, I must say that I think, Chairman Gray, you have been among the most forthcoming people that I've encountered in 20 years in the Congress in terms of being direct about the nature of the problem.

I don't mean just today but in other appearances. And I think that's been very helpful, the fact that you've laid the cards on the table—all of them—and I don't mean to leave out Bill Seidman, because that's always been his practice over a lifetime as well.

So we're fortunate to have two people here today in these capacities who operate that way.

But, in the case of the thrift problems, it seems to me that, as I've watched what's been done, while not everybody may agree with all the steps you've taken—and that's part of the game—it seems to me you've done everything humanly possible to try to meet these problems.

And I appreciate the effort that's been made. I think we're making progress. It's never going to be that everybody's happy with everything that's done. But if you wait for a concensus of 100 percent, you'll never do anything.

In any event, I think we've come a long way. We're not out of the woods by any means. So let me just ask you in that respect, under Secretary Gould, when he was here last week, testified that the FSLIC faces possible losses of as much as $15 billion or more, and the liquidation of somewhere between 200 and 461 insolvent thrift institutions that have been allowed to remain open, but which might have been closed.

Now, whether that's the exact number or not, it's something certainly in that range. But it's my understanding that at yearend 1985, the FSLIC net worth or total insurance reserves stood at some figure just over $6 billion. So you have that to draw on at the moment as against whatever this large size of possible obligations that may have to be met.

I'm just wondering, it seems to me then that the fund is running a potential deficit of something on the order of $9 billion or thereabouts. I am wondering if that's correct.

If not, how should we view it and how seriously do you see that problem that we're facing at this time.

Mr. GRAY. Well, as I've indicated in my statement, Senator, we believe that assistance costs will be somewhere in the nature of $16 billion over the next 3 years to resolve the cases we have.

Of course, we have been prevented from dealing with some of these more difficult and more expensive cases simply because our resources are limited. We also have this Government accounting scheme which establishes what we call the unobligated reserve, which, insofar as dealing with these cases, is substantially less in the real world. It's not $6 billion, it's roughly a third of $6 billion that we can use to deal with these kinds of cases.

Now we have proposed the outline of a plan which would enable us to raise sufficient capital for the FSLIC to be able to more expeditiously deal with the 216 cases that we know of now.

We recognize that there will be others and we think that this financial plan, which is exciting to me, is certainly within our capacity to do because of the manner in which the components of the Federal Home Loan Bank System are organized and work together.

And with this kind of program, I think that we could put our problem behind us over the next 3 to 5 years, with the kind of regulatory actions, the kind of legislative recommendations that we're making, and the need for increased discipline in the system by the regulators. I would add to that, by the way, our exploration of the proposal to gradually phase out net worth requirements for our thrift institutions over 5 to 6 years to 6 percent. This would provide an added cushion to our institutions. This is particularly important to get on with now, given the low interest rates we have, which our institutions are benefiting from.

The time to begin these straightforward, important actions is now. But I think a combination of all of them can enable us in the thrift system—and I include the thrift institutions in that system—

to put these problems behind us and to move forward over time, and to provide the kind of real recovery that we need for the industry as a whole.

SOME STATE LAWS ENDANGER THE SYSTEM

Senator RIEGLE. Let me ask you this. The public wouldn't necessarily know this, but State laws affect exactly what kind of activities savings and loans can be involved in, depending upon what State they are in. Nevertheless, standing behind that is a Federal guarantee, the FSLIC protection. We view the savings and loan as one. So the full faith and credit of the United States stands behind that.

To what extent have some State laws which have given savings and loan a much broader playing field go out and become involved in different activities? To what extent has that, if at all, been part of the problem of thrifts getting into trouble, the ones that have, and putting all this pressure on the FSLIC fund?

Mr. GRAY. I think that the proof is in the pudding. When you look at our most severe problems, you find that they are or they tend to be located in States where, particularly across the Sun Belt, there are more liberal, and in the case of my own State of California, almost infinitely more liberal authorities that have been granted to State-chartered institutions. As you suggest, it is important to the Federal insurance fund, which is backed, I believe, implicitly, at least by the full faith and credit of the United States, to be able to better underwrite the risk of loss to that insurance fund. Because of this, we, of course, brought before the Congress, our proposals for risk premiums which deal directly with this issue.

Senator RIEGLE. Let me just stop you there. Should we be prepared to continue indefinitely into the future, providing the Federal guarantees for an unlimited expansion into new areas of business by savings and loans in given States? Is that really sound, or should we try to draw the line here somewhere?

Mr. GRAY. No. I will point to what former Bank Board Chairman Jay Janis said in a hearing before the Financial Institutions Subcommittee over on the House side last week. He said that the California State law was reprehensible. I think he used that term. He described it in most pejorative terms. States, of course, in our dual thrift system, do set operating authorities for their own thrifts. How we are able to underwrite the risk of loss for those kinds of activities is what we ought to be dealing with, it seems to me.

Secretary Gould, when he testified before this committee a week or so ago, said he believes that the way to deal with this was to place any activity that went beyond what the Congress found suitable for federally insured thrifts in a holding company. I think that is an interesting concept. I think it is deserving of a good deal of study by the Senate and the House. It is not a panacea in its own right. But what it says is that those activities, if they were in a holding company would not, if they failed, pull down the insured institution from beneath it. Our risk premium proposal would also accomplish the same thing, if we were to price activities for the risk of loss beyond what the Congress has intended. Whether the Congress should, by Federal statute, determine that States should be more limited in the kinds of activities they provide their own State-chartered institutions is a matter that Congress ought to decide.

What we, as insurers, want to do is underwrite and have the means to underwrite the risk of loss.

Senator RIEGLE. That sounds like it is part of the problem. It may be a growing part of the problem.

Chairman Seidman, let me ask you, it appears from your statement on page 24, that you are less than enthusiastic about the increased jurisdiction that OMB has asserted over 3 of the 4 bank regulatory agencies. How has the OMB affected the independence of the FDIC, and what do you think ought to be the relationship between the FDIC and OMB?

POSSIBLE OMB JURISDICTION

Mr. SEIDMAN. At this point, we have just heard from OMB in the last, I guess, 3 or 4 weeks, that they intend to take jurisdiction over us under both Gramm-Rudman and the Horschman Act.

At this point, we have reduced our budget in accordance with the percentage required by Gramm-Rudman. Beyond that, we have been studying whether we believe they have the legal right to do this, also trying to find out what it would mean to us.

The CHAIRMAN. Senator Riegle, can I interrupt at that point? I had not heard this yet. I think, as you know, I have read the letters on this particular subject and OMB ought to be put on notice that that is just stupid, just ridiculous. You go ahead with your legal studies, but here we are talking about safety and soundness, and we are talking about funds that are not taxpayers' dollars, they are generated by the institutions, and to put this under Gramm-Rudman is just absolutely stupid. I cannot believe the OMB has any brains down there, that don't understand the difference between taxpayers' dollars and the budget deficit. And nobody feels more strongly about that than I do. This is a separate issue. It is separate funds, and when we have got banks on the trouble list, and they want you to take cuts at the same time, you are talking about hiring more examiners and paying more to keep them, that there has got to be some brains in that organization, and I hope somebody here who is representing OMB and goes down and tells them the message.

They are going to have one hell of a fight with this chairman, because I put up with a lot of crap out of that organization, but I can't put up with this kind of utter stupidity, where it isn't taxpayers' dollars and has no effect on the budget. And we are trying to get banks off the trouble list to shore up the financial institutions of this country.

So let's put a fee on OMB operations and cut a few of the lamebrains out down there. [Laughter.]

Thank you for letting me interrupt you. [Laughter.]

Senator RIEGLE. Mr. Chairman, I am pleased to hear that. I feel even more strongly about it. [Laughter.]

But I think it is important that the signal be sent, and it is very important to hear the comment from you directly, Mr. Chairman, as it just has with the support of the rest of us here. I think if there is any doubt about this, it needs to be settled and settled fast. This is not a problem to horse around with, because we've got serious work to do, and I would suggest that if we can't settle it face to face with some kind of legal determination that is agreeable all around, then I think if it takes an amendment offered on the floor, or whatever it takes, it ought to be drafted and done, because these problems are too serious. We have what I consider to be sort of bureaucratic interference that could cause us to have a manageable problem become an unmanageable problem. We have too many banks on the trouble list. We have too many savings and loans on the trouble list. We need the examiners. We need the capacity to respond. We need to respond rapidly. We have competent officials trying to do this, and the notion that we are going to start cutting back at the time when we need to, if anything, increase our efforts, is just absolutely nonsense.

The CHAIRMAN. I've just asked the staff director to prepare a letter to OMB, and I would hope before the day is over, every member of this committee signs it. He has my permission to tone it down a little bit—[laughter]—but not too much.

If the Senator would help me, we will see if we can get a letter signed by every member of this committee, on both sides of the aisle, before the day is over.

Senator RIEGLE. I would appreciate that, and I think that would be helpful, and if that doesn't get the job done forthwith, let us know, and we will be prepared to take other steps.

It is clear from your statement, Mr. Seidman, that you favor full interstate banking. It is not clear to me, I see us getting there, and what the timetable is. I am wondering, for example, and this is a starting point, do you see us going for a period of time with regional banking arrangements and then with some triggered beyond that down the track, where you go from regional to full interstate banking?

What do you have in mind and what kind of a timeframe, do you think would be best in terms of that viewpoint?

INTERSTATE BANKING

Mr. SEIDMAN. Senator, I feel so good, I can hardly answer. [Laughter.]

May I answer that by saying that my experience in Arizona, where I headed up the Governor's Commission on Interstate Banking, was that as we studied interstate banking and how it would affect Arizona, we came to the conclusion that interstate banking was on its way and the technology and other developments simply meant that it was inevitable. The question then became what Arizona should do about it. And they decided in an unanimous committee vote that Arizona ought to go directly to interstate banking. Other States have come to other conclusions, that they would rather start with a regional effort, and some have triggers to go to interstate or not.

It seems to me that the States are moving along pretty well at the moment in that area, that it may well be that there is no need at this time for the Federal Government to move further in that area, since I think it is happening out there pretty well without requiring Federal action.

EFFECTS OF THE TAX REFORM BILL

Senator **Riegle**. Let me ask you one other question along somewhat related lines, and that is, in the House tax bill, H.R. 3838, that contains a number of provisions affecting financial institutions, and among other things, as you know, it would repeal the deductibility of contributions and loan loss reserves in banks with over $500 million of assets, and it would also repeal net loss carryback operations. It would actually facilitate smaller financial institutions to compensate for their ability to diversify their loan portfolios. To many of us, it looks as though the job, you know, you're trying to do some consolidating, and you are trying to merge weaker institutions into stronger ones.

But do we really want to be moving in this direction with these tax law changes right now? Won't that make it more difficult to accomplish some of these things, if we were to leave the law as is?

I would be happy to hear either of you respond to that.

Mr. **Seidman**. I will start out simply by saying, I have already addressed a letter to the chairman expressing my concern about those changes. I think especially the bad debt reserve deduction is part of normal GAAP accounting. It is almost inconceivable that on the one hand, we were fighting to get these reserves up in order to maintain the safety and stability of the system, and on the other side, we are taking away the deduction. We are also working to try to effect mergers to keep institutions from closing and keep the trauma that causes out of the community. At the same time, that change with respect to the operating loss carrybacks would be deterimental to that effort, so we feel very strongly on both those issues.

Mr. **Gray**. Let me follow up on that. I am very, very deeply concerned about the tax reform bill that has come over from the House, with respect to its impact on the FSLIC. For example, the approach contained in that bill would cause FSLIC assistance, which is used to facilitate mergers of healthy and failed institutions, to be taxed. If that were to happen, our ability to put together these kinds of marriages of healthy and failed thrifts would come to a screeching halt.

Beyond that, the bill, as I understand it, would no longer allow FSLIC assistance in these cases to be counted as equity, that is to say, as capital. That, in addition, would, it seems to me, be very detrimental to the efforts that we have been trying to make. It seems to me that this committee and the members of the Senate are going to have to address this straightforwardly, because all the efforts that we are making will be undone, it seems to me, if these kinds of provisions were included in any final law.

Senator **Riegle**. Mr. Chairman, on that point, I might just say, it is a fairly esoteric subject. This is the kind of thing, with the big cosmic sweep of the tax reform bill, that tends to be treated as a sideline issue, but I think it may be important enough to enable us working through these problems with both commercial banks and savings and loans, that we may want to think about as a committee maybe, if we have a strong feeling on it, and sending an advisory over to the Finance Committee to try to highlight the implications of this area.

When I hear two top regulators here saying they are very concerned about that change in the tax law and making it more difficult for them to be able to accomplish the kind of necessary strenghening of the system that is needed, it may well be that if we don't help highlight that for the Finance Committee, it will not be seen in the context of its implications for the soundness and the safety of the financial system the way it properly should be.

So I just raise that with you.

The CHAIRMAN. Well, I would say to the Senator from Michigan that I would agree, and furthermore, that the report we are sending to the Finance Committee, as a result of our hearings on the tax implications overall, that is expressed. Hopefully—the reason I turned to staff is that, hopefully, it can be printed before the day is over, if not, tomorrow. But we are including the recommendation.

Senator RIEGLE. Well, I think that perhaps the chairman and I and others who may have an interest, I think, with some of our colleagues on the Finance Committee, at some point, too, that we may want to try to fight that issue, because I worry about it sort of just sliding down to the bottom without anybody looking at it.

I just want to ask one other question of you, Mr. Seidman, and that is this: if we go the risk-based premium route, there is a certain attractiveness to that concept, but you know, when you have sort of written a concept into the current reality, if you look at the problem, particularly in the Southwest now, where you have this multiple set of problems that get a lot of institutions in trouble, and the same is true on the thrift side, it seems to me that if we were to try to go with a risk-based premium now, you'd sort of catch a lot of people off balance, and in a sense, you tip them further off balance. In other words, you'd drain them with a higher insurance premium at the very time you are struggling to keep their head above water.

I am just wondering if we are not enough out of kilter right now that that may make a risk-based premiun concept, while attractive as a general idea, maybe not workable for that reason.

I just wonder how you see us reconciling that.

Mr. SEIDMAN. First, I think, while risk-based premiums are desirable and would be an improvement, I don't think they are essential to the operation of the system. Therefore, the matter of instituting them immediately, I don't find to be very convincing. Unfortunately, risk-based premiums work like the marketplace, which is somewhat heartless, in the sense that it charges people who create risk, regardless of circumstances. So it may well be, I would envision that if this kind of power were given to us, considering that we still have to determine exactly how risk is to be determined, we need to have at least a substantial part of the industry agreeing with us, and how we do that, but the possibility of actually people paying extra money, and this, I think, is probably at least 2 years away.

Mr. GRAY. Senator, if I may just add, our risk-premium approach that we have sent up for the last several years differs very substantially from the approach, I believe, the FDIC is following. As I indicated earlier, when we were talking about the Federal-State thrift system and how we needed to have the two to underwrite risk, I would also say that we have, of course, available to us the risk-based capital approach, and we intend to move forward, irrespective of whether the Congress would agree that we should be given authority to establish the risk premium plan to deal with this underwriting problem for insurance purposes, using risk-based capital approaches.

Senator RIEGLE. Thank you.

The CHAIRMAN. Gentlemen, I only had one more question to you, and that was the impact of Gramm-Rudman-Hollings. I think Senator Riegle gave me the opportunity to express my feelings on that. I don't need to say anything further at this time.

I do have a letter, however, addressed to Senator Proxmire from Senators Baucus, Zorinsky, Boren, Exon, and Harkin. They have some questions they would like you to respond to, Mr. Seidman. So we will see that you get a copy of those.

The CHAIRMAN. Thank you very much for your testimony.

The committee is adjourned.

[Whereupon, at 11:15 a.m., the hearing was adjourned.]

[Response to written questions of Senators Baucus, Zorinsky, Boren, Exon, and Harkin follow:]

[Response to committee questions and additional material supplied for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR D'AMATO FROM CHAIRMAN EDWIN J. GRAY, FHLBB

Question 1 (Senator D'Amato)

1. On pages 4 and 5 of your testimony you mention the development of a joint proposal to develop plans to strengthen FSLIC. Could you give us an idea about what you are specifically considering or the various options you have evaluated?

Answer:

The Board considered three major sources of recapitalization before reaching the current plan, which blends industry and Federal Home Loan Bank resources. These sources were the U.S. Treasury, the industry itself, and the FHLBanks. A taxpayer bailout was dismissed as not consistent with this Board's policy thrust as well as being politically infeasible in a period of large budget deficits. The savings industry is currently devoting close to 25 percent of its annual profits in special assessments to FSLIC. This decreases the amount of earnings which can be retained to build their capital bases. A complete reliance on the FHLBanks would have impaired their high credit standing in the capital markets, which would have significantly increased the cost of advances to the industry. The current proposal balances these industry and FHLBank concerns in relation to their respective abilities to address this problem.

In essence, here is how the recapitalization plan would work.

Over the next five years or so, the Federal Home Loan Banks would contribute to a separate corporation -- which would operate under the direction of the Federal Home Loan Bank Board -- as much as $3 billion in retained earnings. The separate corporation would be called the Financing Corporation. This separate Financing Corporation is necessary to insulate the FHLBanks from any possible reduction in their superior capital market standing which direct lending to the FSLIC could entail. The Financing Corporation would serve the purpose of buying capital stock in the FSLIC.

Each of the Federal Home Loan Banks is now required by law to retain 20 percent of its earnings. These retained earnings cannot be paid out in dividends by the FHLBanks to their shareholder member institutions. Under the recapitalization plan, all or a portion of these retained earnings -- as necessary -- would be employed to purchase stock in the Financing Corporation.

The FHLBanks' retained earnings now aggregate to some $1.8 billion. Within five years or so, these retained earnings are expected to grow to around $3 billion. This should occur even under very stagnant growth assumptions for the FHLBanks. Not one penny of the primary capital of these FHLBanks -- that is to say, the stock held in the Banks by member thrift institutions -- will ever be touched. This has been done in the plan to further protect the superior capital market position of the FHLBanks.

The separate Financing Corporation, to which the retained earnings of the FHLBanks would be contributed, would be operated by a three-person directorate, including the Director of Finance of the Office of the Federal Home Loan Banks and two Federal Home Loan Bank Presidents who would be selected for one year terms.

The Financing Corporation would operate in two concurrent modes -- as that of a funding corporation and, in a sense, as a kind of trust. It would have all the same attributes as that of a government agency operating in the capital markets. It would have no guarantees from the Treasury or the FSLIC. Further, it would have no paid staff of its own, but would utilize the existing staff resources of the Federal Home Loan Bank Board and the FHLBank System.

And how would the Financing Corporation utilize these FHLBank retained earnings to bring about FSLIC recapitalization?

First, the Federal Home Loan Banks will buy stock in the Financing Corporation with cash or its equivalent. Under our plan, these funds would then be leveraged for the purpose of borrowing, for example, $10 to $11 billion in the capital markets. We would use a five-to-one leverage ratio in the current market environment. However, that leverage ratio could increase as conditions warranted. The borrowings made by the Financing Corporation would be in the form of long-term bonds. This debt would be raised gradually, as necessary, and only as the FSLIC's needs dictated, over the next five years or so. If, for example, it were necessary, to raise $10 billion over the next five years, $2 billion could be raised per year.

If, as some may be suggesting, the case resolution costs at the FSLIC were less than the $16 billion I estimated over the next five years or so, then the Financing Corporation would utilize fewer FHLBank retained earnings for leveraging borrowings in the capital markets. It is this kind of flexibility which enables our FSLIC recapitalization plan to deal with the insurance fund's case resolution needs on essentially an "as necessary" basis.

In addition, the FSLIC would have a strong financial incentive not to request more funds than it could spend in a given period of time as the costs of any such borrowed -- but unused -- funds would exceed the re-investment rate on its own investment portfolio. Further, I believe Congressional oversight would pay particularly close attention to how effectively and carefully the funds were being used to accomplish case resolution.

The long-term bonds, leveraged and issued by the Financing Corporation, would have maturities of generally from 15 to 30 years. Such long-term maturities are quite different from the natural markets of the FHLBanks, which normally range from one to ten years. The far longer debt maturities of the Financing Corporation are intended to provide the FSLIC a sufficient period of time to meet the FSLIC's case resolution needs over the next five years or so and then return to a very healthy state out into the longer term future.

The long-term debt raised in this fashion would be invested by the Financing Corporation in capital stock of the FSLIC. Two classes of stock would be issued: redeemable non-voting capital stock equal to the potential $3 billion in FHLBank capital invested in the Financing Corporation, and non-redeemable capital certificates of, for example, $7 billion - $8 billion for the residual capital market borrowings.

The new capital stock held by the FSLIC, combined with current reserves, income from FSLIC investments and insurance premium contributions made to the FSLIC over the next five years or so, could bring the total resources of the insurance fund during the period to as much as $25 billion, as I mentioned earlier. Again, if the cost of case resolution to the FSLIC is less than we have projected, then less borrowing will be required of the Financing Corporation, and thus less retained earnings will need to be contributed from the retained earnings of the Federal Home Loan Banks.

The Financing Corporation will be paid stock dividends by the FSLIC to cover ongoing, regular interest payments due the bondholders. These interest payments will be passed on to the bondholders by the Financing Corporation. The FSLIC's continuing ability to generate significant income from insurance premiums over time should assure the investors in the bonds of the regularity of payment of these dividends.

Payment of the principal on the bonds would be insured by the Financing Corporation, not the FSLIC. In this way, no long term balloon payment would be guaranteed by the U.S. Government. To retire the bonds at maturity, the Financing Corporation --acting in a kind of trust capacity -- would invest the retained earnings contributed by the FHLBanks in top quality securities. The long-term, continuing return on the investment of these funds, over 20 to 30 years, would compound enough interest to assure repayment of the principal on the bonds. Such investments are most easily accomplished by the purchase of zero coupon bonds, but other means are also available.

Thus, the same FHLBanks' retained earnings -- which, when contributed to the Financing Corporation, would serve to leverage borrowings in the capital markets -- would play an offsetting role by defeasing the principal on the bonds. In other words, the returns on the long-term bonds purchased by the Financing Corporation, again employing the retained earnings of the banks to make these long-term investments, would be used to retire the bonds at maturity -- that is to say, pay back the principal to the bondholders when the bonds mature.

Summing up the explanation thus far, then, the FHLBanks will contribute retained earnings, and retained earnings only, to the Financing Corporation. The primary capital of Federal Home Loan Banks -- that is to say, the thrift industry's investment in the stock of the Federal Home Loan Banks -- is never, ever touched by this recapitalization, and can't be touched because our enabling legislation will prohibit it, by statute.

The increase in capital stock and certificates purchased by the Financing Corporation in the FSLIC will increase the insurance fund's strength to resolve FSLIC cases in a more timely manner over the next five years. Such stock will be considered a budgetary receipt, not an expenditure. Up to $25 billion in cases could be resolved, but the plan is flexible in that funding is only generated gradually, over time, as needed.

The purchasers of the debt instruments -- that is to say, the bondholders -- will be assured continuing interest payments over time by FSLIC's premium base -- and -- because of the compounding effect of the long-term investments made by the Financing Corporation, again using the contributed retained earnings of the FHLBanks, the returns on these investments will be sufficient to retire the principal of these bonds at maturity.

The other part of the recapitalization equation involves a five-year phase-out of the special premium assessment (the one-eighth of one percent of deposits premium) commencing in the fourth quarter of 1986. We chose this period because, as we ran the numbers, such a five-year period was necessary to make the plan work for a $10 to $11 billion borrowing program. The phase-out we're recommending is a straight-line linear phase-out, but it would not have to take the form of a linear phase-out over the five-year period. Others have suggested it could conceivably be a faster phase-down at the beginning, but with relatively higher premium payments during the last three years, compared to what would be the case with the straight-line phase-out. The straight-line phase-out works this way: 83 percent of the one-eighth special assessment in the first year; 67 percent in the second year; 50 percent in the third year; 33 percent in the fourth year and 17 percent in the fifth year.

Given the very high profitability of most of the industry now, and continuing anticipated levels of good to very good profitability in at least the next year or two, the arguments for accommodating a linear phase-out along the lines I have described seem, in my view, to be especially compelling. In any event, the numbers indicate that we need to raise $4.3 billion from the phase-out of the special assessment to make the plan work.

In my view, the rather compelling reason for choosing the fourth quarter of this year to begin the five-year phase-out of the special assessment is because it is difficult to imagine that we could achieve passage of the enabling legislation to implement the recapitalization plan before the summer. It will also take us a few months to put our debt marketing and necessary operating systems in place.

Remember, the recapitalization plan requires that the FSLIC make ongoing interest payments to the bondholders, through the Financing Corporation, during the entire life of the bonds. Again, a combination of capital stock invested in the FSLIC, returns on FSLIC investments, current FSLIC reserves and a continuing infusion of premium income, in both regular premiums and the funds which are infused by the five-year phase-out of the special assessment, all are necessary to make the program work in the short and long-term.

This is a long-term program. The Financing Corporation, which the recapitalization program establishes, will sunset, by law, in the year 2026 -- forty years from now. Over that period of time, we believe the contribution made by the Federal Home Loan Banks can be repaid by the FSLIC with interest to cover opportunity costs lost by virtue of early contributions made by the Banks to the Financing Corporation. These repayments would be tied to the condition of the FSLIC fund, as measured by the ratio of FSLIC reserves to deposits. All such payments would be made, if appropriate, when the last bonds mature.

For those thrift institutions which are FDIC-insured members of several of our Federal Home Loan Banks, we have established a special allocation formula throughout the FHLBank System to reflect special concerns. The allocation formula, which was jointly devised and agreed to unanimously by our 12 Federal Home Loan Bank Presidents, uses as a base the amount of assets held by FSLIC-insured members of each Federal Home Loan Bank. Generally speaking, each bank will contribute roughly its share of retained earnings to the Financing Corporation, based on the size of its FSLIC-insured members.

Here are some additional thoughts about FSLIC recapitalization.

First, it seems to me that institutions that are FSLIC-insured -- as well as Federal Home Loan Bank Boards with heavy responsibilities for the health of the FSLIC well out into the future, along with this and future Congresses who exercise ultimate responsibility for the well-being of our overall Federal Deposit Insurance System --must take into strong account now the need to maintain a continuing liability base in the industry which is sufficient to make this recapitalization achieve its goals over the life of the plan. In other words, it is in everyone's interest --and indeed the public interest -- to work now to assure that measures which are necessary to maintain the continuing base on which FSLIC premiums are assessed, both in the short and long-term future of the plan, are taken.

In my view, it is imperative that a succession of Bank Boards --that will be responsible over time for making the overall approaches contained in this plan work successfully --retain the necessary flexibility contained in certain current statutory provisions to make adjustments as needed.

The enabling legislation required to make the recapitalization approach I have outlined work under varying circumstances over the life of the plan should not be so rigid as to preclude the exercise of necessary discretionary flexibility by the Bank Board to deal with unanticipated circumstances in a manner which is truly responsible, and responsive to the most demanding requirements for maintaining a safe and sound thrift deposit insurance system. I believe that taking care to assure that such discretionary flexibility is retained in the law is very much in the public interest.

I believe the Congress has a unique window of opportunity to take swift action on the joint Bank Board-Administration recapitalization proposal during this period of low interest rates. The three members of the Bank Board strongly believe that the recapitalization plan provides sufficient financial and organizational resources to enable the FSLIC to establish more ambitious targets, and resolve more cases in a more expeditious manner. By providing additional resources to the FSLIC to begin a program of more timely, as well as careful and cost-effective case resolutions now, confidence in the FSLIC will be strengthened.

Question 2 (Senator D'Amato)

1. You state that there is no role for private insurance. How do we facilitate the shift from private to FDIC insurance? Should we really be doing this at present due to the strains that already exist on FSLIC funds? I understand that several institutions in North Carolina had trouble shifting from private to FSLIC insurance. Have they all been converted and, if not, could you tell us what is causing the delay?

Answer:

While the concept of private insurance is attractive in theory, it would appear that private plans are unworkable in today's environment, and indeed, few private plans still exist. Events in Ohio and Maryland with state-sponsored, private insurance funds have unquestionably affected the public's perception of these plans. The failure of these private funds also created significant instability in the financial markets. The Bank Board and the various Federal Home Loan Banks have worked closely with state thrift regulatory authorities to facilitate conversion to FSLIC insurance to ensure that this process can be accomplished without crisis or panic.

In determining eligibility of privately insured institutions for FSLIC insurance, the Bank Board has established a three part test that includes a minimum net worth requirement, viability projections and a qualitative eligibility review. As a result, only institutions that present acceptable risks to the fund will be approved for FSLIC insurance. Of the 29 North Carolina institutions previously privately insured, only 4 were unable to qualify for FSLIC insurance.

Question 3 (Senator D'Amato)

3. You advocate extending the net worth certificate program. How much longer should it be extended?

Answer:

The Bank Board has recommended that the net worth certificate program be extended for three years.

Question 4 (Senator D'Amato)

4. Tuesday, when addressing the financial strains placed upon institutions insured by the FDIC, we discussed the application of FASB 15 as a means of assisting institutions with large agriculture and petroleum loan portfolios. Could FASB 15 be applied to assist institutions insured by the FSLIC? Are you advising FSLIC insured institutions that they can utilize FASB 15?

Answer:

Thrift institutions can use FASB 15 as an accounting method for restructuring a troubled loan. However, the Bank Board has never advised FSLIC-insured institutions to use FASB 15. Under the Board's regulatory standards, loan quality is reviewed by examiners in accordance with adequacy of collateral standards and the recently promulgated classification of assets rule. 50 Fed. Reg. 53,275 (December 31, 1985). These review standards incorporate factors that are broader than the cash flow standard of FASB 15. For example, institutions utilizing FASB 15 run the risk of a write-down in the event that the market value of the collateral is less than the loan.

__Question 5 (Senator D'Amato)__

1. On page 10 you discuss the adverse effects of H.R. 3838 on S&L's. Assuming H.R. 3838 is enacted, could you estimate the number of troubled thrift institutions that would require FSLIC assistance? Have you expressed your concerns to Senator Packwood and other members of the Finance Committee?

Answer:

The Bank Board estimates that FSLIC financial assistance will increase by $4.27 billion if H.R. 3838 is enacted. My fellow Board members and I have expressed our concerns to Senator Packwood and other members of the Finance Committee.

__Question 6 (Senator D'Amato)__

6. Last week, Treasury Undersecretary Gould suggested that it was fine with the Treasury Department if the nonbank bank loophole remained unclosed unless such a provision was part of a comprehensive bank deregulation bill. Do you agree with Secretary Gould or do you think that it is a matter of some urgency that the loophole be closed as soon as possible? What is the effect upon FSLIC of our failure to close expeditiously the nonbank bank loophole?

Answer:

The Bank Board has consistently supported eliminating the "nonbank bank" loophole. We believe it should be closed shut once and for all. In light of the Supreme Court's decision in __Board of Governors of the Federal Reserve Board v. Dimension Financial Corp.__, we believe it should be closed shut once and for all. The loophole threatens the FSLIC's ability to use effectively its statutory authority to reward acquirers of failing thrifts with interstate franchise rights through the use of a bidding procedure. Congress enacted this reward authority as part of the Garn-St Germain Act to increase the FSLIC's flexibility to respond to supervisory problems and better husband its resources. Such flexibility for the FSLIC is a national priority that is more important today than even before. While it is impossible to precisely measure the impact the nonbank bank phenomenon has, and has had, on the FSLIC's ability to resolve problem cases, many bidders who were willing to negotiate seriously to acquire a failed thrift to achieve interstate operating rights have disappeared.

__Question 7 (Senator D'Amato)__

7. We have discussed risk related premiums based on the types of activities that an institution undertakes. Wouldn't it be better to limit the scope of permissible activities than to just require those engaging in riskier activities to pay higher premiums since it is hard to figure precisely the appropriate premium for certain activities? For example, in earlier

appearances you stated that the activity that troubled you most was direct investment in real estate. Shouldn't we eliminate this activity rather than have institutions that engage in direct real estate investments pay higher premiums? After all, once an institution fails, the payment of a higher premium really does not matter much with regard to the potential drain on the FSLIC fund, does it?

Answer:

It must be recognized that each type of investment activity has some risk associated with it. For example, the fixed-rate, fixed-term single family mortgage is extremely vulnerable to interest-rate risk. In fact, the prevailing interest rate environment during the past six years graphically demonstrates the types of losses that can occur as a result of the interest rate risk component of fixed-rate single family mortgages. The Bank Board believes that thrift institutions should be allowed to engage in activities that generate contracylical income and allow diversification of risk among a number of types of investments. This structural flexibility is vital to assure the industry's long-term viability, and to assure its ability to maintain the core home lending focus in fluctuating economic conditions.

The Bank Board's risk-related premium proposal attempts to balance the need to preserve appropriate diversificatin opportunities for thrifts while better protecting the FSLIC from increased risk of loss to the fund inherent in a deregulated operating environment. The additional premium imposed on an institution for engaging in a "more risky" activity will not cover the FSLIC's losses if the institution fails. However, premiums priced to cover the risk of loss resulting from any activity or group of activities would have to be collected in advance to cover all losses attributable to that activity.

Question_8_(Senator_D'Amato)

8. Once a risk was assigned, how often would the risk assessment be reviewed? How frequently would the premiums be adjusted?

Answer:

We anticipate that such risk premiums would be reviewed and repriced as necessary at least semiannually,

Question_9_(Senator_D'Amato)

9. Isn't the maintenance of strict confidentiality about the identity of above normal risk institutions necessary so that the public's confidence in that institution does not erode?

Answer:

The Bank Board will, of course, maintain strict confidentiality about the risk related premiums for individual institutions. Above average premiums can not be automatically assumed to indicate the existence of a "problem" institution. Therefore, well managed and well capitalized firms whose risk related premium is higher than average should not have to worry about being labelled a "problem" institution simply due to their premium levels.

Question_10_(Senator_D'Amato)

10. Have you developed some sort of sound actuarial standards for assigning risk under the system you propose?

Answer:

Bank Board staff is currently working on a set of standards for assigning risk under our risk premiums proposal.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM CHAIRMAN EDWIN J. GRAY, FHLBB

Question 1 (Senator Proxmire)

1. As I understand your proposal for re-capitalizing the FSLIC, the Home Loan Banks would borrow $10 billion over twenty to thirty years in order to shore up FSLIC. The money would be repaid over this period from earnings realized by FSLIC and the Home Loan Banks. However, the additional special assessment levied by the FSLIC would be phased out over 5 years.

If we are going to burden the Home Loan Banks with debt for up to thirty years, shouldn't the special assessment be continued until the debt has been repaid? Why phase it out so soon?

**(Follow-up) How will FSLIC ever earn enough money to repay the interest and principal on the $10 billion and re-build its reserves if it doesn't have the income from the special assessment?

Answer:

Our current baseline cash flow projections demonstrate that the FSLIC could resolve between $20 and $25 billion in gross case resolutions over the next five years. Thereafter, they could still resolve a significant level of case resolutions as the regular premium will be well in excess of $1 billion annually at that point. Another $1 billion or more per year will be received from deferred payments on the large number of assets that were disposed of in the earlier years.

The FSLIC will need $10 billion in external borrowings, up to $3 billion from the Federal Home Loan Banks, an additional $4.0 to $4.5 billion in special assessments as well as the existing resources of the FSLIC. The FSLIC will not be responsible for the repayment of the $10 billion debt; the FHLBank investment will be used to purchase instruments to guarantee repayment of the debt. The FSLIC will primarily be responsible for the interest on the debt. The cost of $10 billion debt in today's market would be $850 million per year. The FSLIC's annual cash inflow from investments, the regular premium and asset realizations should not fall below $2 billion per year for the next ten years. It should grow to over $10 billion on an annual basis by the year 2013.

The assumptions utilized for deposit growth are less than historically demonstrated levels and the $25 billion in case resolutions far exceeds our current $16 billion estimate of the problem. Even if these conservative assumptions did not hold up, the Board has no intention of relinquishing its one-eighth of one percent special assessment authority. This could provide an additional $1.5 billion per year after the first five years, if much worse than expected events materialize.

Question 2 (Senator Proxmire)

2. Last week when Secretary Gould testified, he saw no real need to close the nonbank bank loophole. In fact, he rather liked the loophole and thought it ought to be made legitimate in the form of a consumer bank. He also said the Treasury would oppose legislation to close the loophole unless it also contained comprehensive new powers for commercial banks.

Suppose Congress does nothing to close the nonbank bank loophole this year. What impact would this have on the safety and solvency of the FSLIC?

Answer:

If Congress does nothing to close the "nonbank bank" loophole this year, it will continue to have an adverse, even devastating, effect on the FSLIC's ability to attract serious bidders to the negotiating table and, thereby enhance prospects of saving the insurance fund money in the resolution of cases. While it is impossible to precisely measure the impact the nonbank bank phenomenon has, and has had, on the safety and soundness of the FSLIC, many serious bidders who were willing to negotiate seriously to acquire a failed thrift to achieve interstate operating rights have largely disappeared.

Question 3 (Senator Proxmire)

3. There have been some proposals to relax some of the requirements for selling a failed thrift. Some suggest that any company ought to be able to buy a failed thrift without complying with the restrictions imposed under the savings and loan holding company act. Secretary Gould has suggested that the Bank Board reverse its current policy and allow securities firms to buy failed thrifts.

Do you see any problems with these suggestions, and couldn't we achieve the same effect on FSLIC if we closed the non-bank bank loophole?

Answer:

With a single exception, any company can buy a failed thrift as long as it meets essential financial requirements, demonstrates a good record, and shows it is willing to play by the Bank Board's rules. The single exception, adopted as a Board policy in the fall of 1983, applies only to those corporate entities whose activities are concentrated in a very significant way in underwriting of, and marketmaking in corporate securities. The Bank Board adopted this policy because we believed then, as now, that such affiliations present a range of significant competitive, economic, and prudential concerns requiring full congressional guidance to the Board.

Allowing securities firms to acquire thrift institutions and closing the nonbank bank loophole are interrelated but separate issues. The Board believes it is imperative for Congress to act on nonbank banks given their effect on the FSLIC, for the reasons I have described.

L. WILLIAM SEIDMAN, Chairman
FDIC
Questions from Senator Garn

Q. 1. If the Congress were to grant the FDIC conservatorship authority in order to manage the failure of larger institutions, what kinds of restrictions could be imposed to prevent the quasi-nationalization of large segments of the banking industry - either in terms of the length of time for the conservatorship, operating restrictions or other criteria?

A: The FDIC is requesting conservatorship authority to provide more time to examine the loan portfolio and other assets of a failing bank and thereby determine whether an open bank resolution appears feasible. We expect such authority would be used sparingly. However, it may be appropriate for dealing with banks experiencing severe liquidity pressures when the extent of insolvency has not been established. The additional time would likely reduce FDIC costs and the pressures on our liquidation operation.

The FDIC is also requesting authority to establish a so-called "bridge bank". The institution would be closed and a purchase and assumption would essentially be effected with an institution newly chartered and owned by the FDIC. The institution could continue as an ongoing entity with outside management. Eventually, the condition of the loan portfolio would be appraised, needed changes would be made, and the institution would be sold to another bank or to the public. An outside limit to the holding period by the FDIC of about two years might be sufficient.

Q. 2. In your testimony you suggest that the FDIC be permitted to arrange the sale of a multi-bank holding company when it is located in a state with limited branching and its lead bank has failed or is failing - even under such limited conditions, why should the Congress permit what would amount to insuring the entire holding company?

A: It is expected that the sale of a multi-bank holding company on an interstate basis would occur under the "failing" portion of the proposed changes. This would allow a multi-bank holding company to negotiate a private-sector deal with an out-of-state (or possibly foreign) institution when major banking units in the system are in danger of failing. Ideally, FDIC assistance would not be involved. A private-sector deal might be worked out while there is still some franchise value left in the troubled holding company. It is conceivable that FDIC assistance might be used to facilitate such a transaction; however, if the side effects of such assistance involves bailing out holding company creditors, the FDIC's use of such assistance would only be used where the effect is to substantially reduce FDIC costs associated with alternative solutions.

Q. 3. You suggest that banks which are determined to present an abnormal risk be required to pay twice the insurance premiums of less risky institutions. How would the FDIC guard against management of those higher risk institutions taking even higher risks to cover the cost of the increased premiums?

A: A risk-related program is considered more equitable than the current flat rate deposit insurance premium structure. The current structure provides more of an incentive for institutions to take risks, because the insurance premiums stay the same no matter how much risk is incurred. A risk-related insurance program would provide a significant, though not overwhelming, financial incentive for banks to avoid excessive risk-taking, and to correct their problems promptly. Increased insurance premiums would send a strong signal to bank's management and board of directors, and thus, encourage them to evaluate their loss exposure. We do not feel that the proposed insurance premiums are high enough to warrant taking significant risks to overcome the cost. However, we will be closely monitoring these institutions to guard against such actions. Again, our primary goal at this juncture is to start to address the inequity in the current flat rate system.

Q. 4. Currently, what is the FDIC's average cost of managing a bank failure as a percent of the failed banks assets? You mentioned that this cost increases if the failed bank is located in a state with limited or no branching rights. Are you able to provide an analysis of the percentage cost increase in those circumstances?

A: Our estimated cost of handling commercial bank failures in recent years has averaged 15-20 percent relative to the total assets of the failed banks. We caution, however, this loss ratio varies considerably among individual institutions.

We are not able, at this juncture, to quantify precisely the incremental cost of handling failures in states where branching is restricted. In the latter, we experience less aggressive bidding for failed banks and are forced to pay off more banks. Costs of payoffs have been higher primarily because: (1) in a purchase and assumption a premium is paid by the acquiring bank and this has averaged about five percent of acquired deposits; (2) in a purchase and assumption, bank buildings, leasehold improvements and other physical facilities are usually transferred to an acquiring bank at appraised value (going concern), whereas in a liquidation, such values are typically reduced or forfeited; and (3) in a purchase and assumption, an acquiring institution generally takes a considerable volume of loans and other assets of the failed bank at book value, whereas the FDIC is likely to incur losses and expenses in collecting on such assets where a payoff occurs.

Q. 5. What would be the competitive effects of FDIC assessing insurance premiums on foreign deposits?

A: FDIC insurance premiums are 1/12 of one percent of deposits subject to insurance or about eight basis points. In years where there has been an assessment credit, the net premium has been lower. Some of the overseas activities of U.S. banks involve relatively small margins. As a result, we could not say categorically that some of this business won't be impacted by insurance premiums. However, many other factors affect the competitive position of U.S. banks vis-a-vis foreign banks and, in the overall scheme of things, the potential eight basis point cost is not likely to have a substantial impact on the volume or profitability of overseas business of U.S. banks.

Q. 6. Could you provide this Committee with specific examples of how the FDIC's ability to manage failures is impaired if there is no state depositor preference statute?

A: Where depositor preference does not exist, nonsubordinated loans and other nondeposit liabilities are on a par with deposits. In a payoff these bank creditors share pro rata with the FDIC, standing in place of insured depositors, and uninsured depositors. This is also the case for off-balance-sheet and other contingent claimants that establish their position subsequent to a bank failure. In a purchase and assumption transaction involving a failing national bank or a state bank where depositor preference doesn't exist, the acquiring bank assumes all general creditor liabilities. The FDIC typically guarantees the acquiring bank that it will compensate it for undisclosed liabilities and contingent claims that are subsequently established. The FDIC must factor these contingencies into its cost calculations to determinme whether a P&A is feasible. Where these contingency claims are established and are significant, the cost of the transaction to the FDIC is significantly raised. The volume of off-balance-sheet liabilities of banks has increased significantly in recent years, particularly among larger banks. Typically, the claimants are large and sophisticated and able to assess the condition of the guaranteeing institution. Putting these contingency creditors along with other nondeposit creditors below depositors could significantly lessen FDIC costs and reduce the uncertainty associated with P&A transactions. It would also reduce legal expenses and the volume of frivolous lawsuits. In a P&A where depositor preference is applicable, the acquiring bank only assumes deposit liabilities. The FDIC is entitled to recover its entire outlay before other creditors, including contingent claimants, receive any payment.

L. WILLIAM SEIDMAN, Chairman
FDIC
Questions from Senator D'Amato

Q. 1. On page nine of your testimony, you mention that a preferable alternative to universal modified payouts is to do P&A's whenever possible. To do this would require the elimination of impediments to P&A's such as branch banking statutes. By doing this, are you suggesting that we enact legislation to override state branching laws? If we were to follow your suggestion regarding the enactment of a federal depositor preference statute, wouldn't we be overriding the banking laws of 35 states?

A: Our preference would be for states to liberalize their own branching statutes, and many have recently done so. Where state action is not forthcoming in the future, it may be appropriate for Congress to consider an override of state branching laws or, possibly, higher insurance premiums might be charged to banks in those states that operate under restrictive branching statutes. A federal depositor preference statute along the lines that we have suggested would override certain aspects of banking laws in 35 states. It should be noted, however, that most states that have recently reexamined their banking laws and enacted new legislation have enacted depositor preference statutes.

Q. 2 Could you please explain how a federal depositor preference statute facilitates the efforts of the FDIC to the use P&A's more effectively?

A: Widespread enactment of depositor preference laws among the states would be most helpful. This is needed on the Federal level as well as with regard to nationally chartered banks. Depositor preference laws would enable the FDIC to ignore the claims of general creditors, including contingent claimants, in meeting the "cost test" under the FDI Act and increase the likelihood that more purchase and assumption transactions can be arranged.

Q. 3. On page thirteen, you state that the FDIC needs legislation to provide it with more time to handle failed or failing institutions. How much time do you usually have now, and how much time would you need? Would you be able to provide more time by changing the definition of a failing institution so that you or the Comptroller could close an institution down before its financial posture limited the FDIC's options? What are the shortcomings of broadening the definition of a failing institution?

A: Lead time prior to a bank failure varies from a few days to several months. In a considerable percentage of bank failures, we know well in advance that a bank is likely to fail. However, sometimes last-minute efforts to raise capital or sell an institution on an unassisted basis prevent the failure. The timing difficulties for the FDIC relates to the fact that we generally are not able to allow potential acquiring banks to examine the loan portfolios of the failing institutions. Consequently, we are not able to structure transactions where the acquiring bank agrees to assume classified loans or performing loans without some kind of put-back arrangement. Some kind of conservatorship arrangement can provide time for potential acquirors to review a bank's loan portfolio. It appears that a period of six weeks to three months is probably necessary, although even a few additional weeks could make a considerable difference. The matter of defining when the Comptroller can close a bank is a somewhat different issue. I think the relevant issue here is that when some banks are declared insolvent, they are, in effect, substantially insolvent. If the Comptroller could declare a national bank to be insolvent by factoring in some allowance for losses related to substandard and doubtful loans, ultimate losses to the FDIC on failed banks would be reduced. Broadening the Comptroller's authority to close banks could lead to increased litigation and more controversy with respect to bank closing decisions. I suppose it would depend on how far we went in expanding the Comptroller's authority.

Q. 4. You recommend lowering the Garn-St Germain threshold level for interstate acquisitions of failing and not failed banks to $250 million. How many banks would be covered if these two changes were made? (Under Garn-St Germain, only failed banks having assets of $500 million or more can be acquired through an interstate acquisition.)

A: At year-end 1985, there were 524 commercial banks with assets in excess of $500 million. 452 institutions had assets between $250 million and $500 million. Reducing the threshold to $250 million, thus, would increase the number of covered institutions by about 450. With respect to failing vs. failed, we would be considering the same pool of affected institutions. At any point in time, a small number (perhaps a handful) of affected institutions might be defined as failing. However, allowing these institutions to begin to negotiate with potential acquirors could significantly reduce FDIC costs, lead to desired private-sector solutions, and be considerably less disruptive to the banking system.

Q. 5. On page twenty, you note that you submitted a risk-based premium proposal for public comment. I assume that some of the responses were critical to the proposal. Could you summarize some of these criticisms? How would you respond to the critics of this proposal?

A: Approximately 102 responses to our proposal have been received. The majority of them (approximately 85 percent) are supportive of the concept of risk based premiums, although several recommendations were offered for revising the proposed system.

Critics of the Concept

The few responses which were critical of the concept of risk-related insurance premiums made the following comments:

- The FDIC would be penalizing banks that attempt to serve their local community and are adversely affected by the economy.
- Increased premiums will not alter banker's behavior.
- The increased penalty is excessive.
- It would increase the involvement of the FDIC in national banks.

It is recognized that a greater percentage of the banks located in areas suffering economic setbacks will fall into the higher risk category and be subject to higher premiums. It is also recognized that some of the excessive risk experienced by the bank will originate from outside forces rather than management deficiencies, however, this does not change the fact that the excessive risk still exists. It is also true that in any area of economic weakness the majority of banks remain sound. While it may be unfortunate that more banks are penalized in economically depressed areas, it is also unfair for the stronger banks competing in the same market area to subsidize the insurance costs of these riskier banks.

The FDIC has given much attention as to what the amount of the penalty to be assessed should be. While the differential in costs under our proposal is not overwhelming, it is significant and provides a very real incentive to avoid excessive risk-taking and to correct problems promptly once they are identified. Additionally, it is felt that a certain amount of involvement by the FDIC is warranted in any FDIC-insured financial institution that is considered to be excessively risky.

Favor Concept But Offer Recommendations

Several of the other responses, while favoring the concept, offered many recommendations for revising the proposed system. It was recognized from the beginning that the implementation of risk-related deposit insurance premiums would be difficult and it was anticipated that there would be different opinions on the issues by the public.

Cumulatively, the more frequently mentioned recommendations include:

(1) Objecting to the use of CAMEL ratings for high risk-based premiums due to their being (a) too subjective; (b) not disclosed to national banks; or (c) perceived that each of the agencies rate differently.

- It is felt that the CAMEL rating system, because it is the product of an onsite examination, is by far the most reliable method for rating banks available anywhere. The use of the probit analysis system is used to reassure the industry that the risk-based system will operate in an objective fashion. The CAMEL rating will be used only to remove a bank from the high-risk category. It will not be used to place a bank into the high risk group. In other words, the CAMEL rating will be used to validate the more objective statistical rating.

(2) The need to establish some sort of appeal process for banks subject to higher assessment.

- The system was designed to use two independent approaches, the examination rating and the probit technique (which must confirm to each other) to eliminate the need for a formal appeals process.

Because adverse examination ratings trigger more frequent examinations, banks can get their risk classification changed relatively quickly through improved performance. However, it is recognized that many people consider it unfair to impose any system without an appeal process, and therefore this issue is being reconsidered.

(3) There are not enough assessment divisions.

- It is recognized that more assessment divisions would provide for easier step by step improvement for riskier banks. Previous proposals have called for three classes of risk but two are believed initially acceptable. This approach will be simpler in that it reduces the levels of risk which must be measured. The statistical technique used to screen for risk can be adjusted to provide more categories of risk if experience indicates that would be of benefit.

(4) The need to tie higher assessment rates to different types of deposits, such as brokered deposits and foreign deposits, or have lower insurance coverage on these type deposits.

- While some of these comments for insuring deposits differently may have some merit and be worthy of further discussion, it is felt that this does not directly relate to this initial risk-based insurance proposal and that to try and include these issues in this proposal would over-complicate the matter.

Q. 6. Once a risk was assigned, how often would the risk assessment be reviewed? How frequently would the premiums be adjusted?

A: All banks would be subject to having their premiums adjusted on an annual basis. Using the formula produced as a result of the probit technique, we will first rank banks and establish a threshold which would earmark banks as having either normal or above normal risk. Since this formula is based on financial ratios calculated from the year-end Condition and Income Report, this part of the assessment determination will be reviewed yearly. Banks having a composite CAMEL rating of 1 or 2 and which are rated as above normal risk by the probit score would not pay the higher premium for that year. These banks would continue to receive normal supervision and offsite monitoring for a bank of its rating. Banks having a composite CAMEL rating of 3, 4 or 5 and which are rated as above normal risk by the probit score would pay the higher premium for that year. The examination of financial institutions already rated 3, 4 or 5 and earmarked as above normal risk by probit would continue to be reexamined under current supervisory policies. Their probit test scores would be recalculated on an annual basis.

Q. 7. Isn't the maintenance of strict confidentiality about the identity of above normal risk institutions necessary so that the public's confidence in that institution would not erode?

A: The FDIC proposes to keep the identity of above normal risk institutions confidential. The CAMEL rating, which is one of the criteria for determining a bank's risk class, is confidential. The possibility for exposure as an above normal risk institution arises from SEC filing disclosures, subpoena, and other similar type disclosures. In the enabling legislation, Congress may want to specifically address the issue of confidentiality.

Q. 8. Have you developed some sort of sound actuarial standards for assigning risk under the system you propose?

A: We have developed a system that does a good job in determining which banks should be classified as problems, based on several publicly reported balance sheet and income variables. These include various measures of income, capital, and asset quality. We are continuing to try to improve our system and are in the process of modifying and updating our system and incorporating the most recent financial data.

L. WILLIAM SEIDMAN, Chairman
FDIC
Questions from Senator Proxmire

Q. 1. You recommend that the emergency interstate acquisition provisions of Garn-St Germain be expanded to allow the interstate sale of a failing bank. The present law only applies to a bank that has actually failed.

As you know, all three bank regulatory agencies favor interstate banking. However, the Congess has refused to permit unrestricted interstate banking.

If we adopt your recommendation, how can we be sure this authority is not abused by regulators who favor interstate banking. Specifically, what would prevent a regulator sympathetic to interstate banking from simply declaring a bank in Wisconsin or elsewhere to be "failing" and letting CitiCorp or Chase buy it?

** (follow-up) Will you recommend a definition of "failing" that we could put into the law if we decide to adopt your recommendation?

A: The proposed legislation has attempted to incorporate a definition of failing bank. The proposed definition imposes significant restraints on the chartering authority, which must determine that a bank is "in danger of closing." The bill also contains other safeguards for both assisted and unassisted transactions. We believe that the importance of the proposed legislation as it applies to realistically defined failing banks is such that bank regulatory agencies are unlikely to stretch the definition, encourage the wrath of Congress, and jeopardize the future use of such a provision.

Q. 2. If we allow the interstate acquisition of a failing bank as you have recommended, shouldn't we require the State Bank Supervisor to concur that the bank is actually failing in the case of a state chartered bank?

A: Under the proposed legislation, the State Bank Supervisor would make the determination that a bank is failing.

Q. 3. You have recommended that the FDIC be able to ignore restrictions in State branching laws in disposing of a failed bank. As justification for this recommendation, you cite the fact that in 41 cases where the FDIC could not arrange a purchase since May of 1984, 36 occurred in states that have restrictive branching laws. The implication of your observation is that the FDIC incurred substantial additional costs because it had to resort to a depositor pay-off rather than a sale to another bank.

What were the actual losses to the FDIC on these 36 cases? If you can't provide them now, can you for the record with the amount for each bank

** (follow-up) Isn't it also true that even in those cases where the FDIC is able to arrange a sale, it often suffers a loss. If that is the case, it seems to me to be difficult to make a convincing argument that restrictive branching laws are actually costing the FDIC real money. I would welcome whatever documentation for the record that you can provide.

A: It is our experience that payoffs generally are more expensive than purchase and assumption transactions. This is because the FDIC generally receives a premium from an acquiring bank entering a P&A transaction. In addition, the acquiring bank typically is required to assume a significant share of the failed bank's assets. It is our experience that if these assets were placed in a liquidation mode, the ultimate recovery, net of expenses, is reduced and the cost to the FDIC is increased. In addition, payoffs tend to be considerably more disruptive to the local economy and, in particular, to borrowers from the failing bank.

Q. 4. I have recommended that the FDIC insurance premium be reduced while at the same time including foreign deposits in the assessment base. These two actions could be revenue neutral on the FDIC while at the same time, it would permit a premium reduction for the vast majority of banks and achieve greater competitive equity among large and small banks.

This proposal seems to make such good sense, I cannot understand how anyone other than a big bank can oppose it. And yet I detect a certain reluctance on the part of the FDIC to endorse this concept. What is wrong with it? Isn't it the fair and right thing to do?

A: We do not object to your proposal with respect to including foreign deposits in the assessment base. At this point in time, however, it may be appropriate not to reduce the basic assessment (or not to reduce it to the extent as to fully offset revenue increases). Additional revenue could strengthen the position of the deposit insurance fund at a time when potential outlays may be increasing.

Q. 5. I have heard that the FDIC wants to sell its interest in Continental as soon as feasible and would have no problem with selling it to a large out-of-state banking institution.

I don't know whether these reports are true or not, but I want to say here that I think this move would be a disastrous mistake. It seems to me there is a much better option and that is to sell the bank to its employees. If Wall Street can raise billions of dollars at the drop of a hat for a corporate raider, I don't see why a leveraged buyout or similar purchase can't be arranged for the Continental when the time comes for the FDIC to dispose of its interest.

Would you care to comment?

A: Under current law, FDIC cannot sell its holdings in Continental to an out-of-state bank holding company or banking institution Whatever the eventual status of the law, however, our goal when we dispose of our interest will be to maximize the return to the Deposit Insurance Fund to the extent permitted by the then existing legal constraints. This may be by a sale to an out-of-state banking system (if then permissible), by a public offering or, as you suggest, by a sale to the bank's employees. At this time, it is too early to predict which of these, if any, offer the greatest opportunity to the FDIC.

L. WILLIAM SEIDMAN, Chairman
FDIC

Questions from Senator Baucus

In regard to what the individual states can do to lessen the negative impacts of bank failures, FDIC needs to address the following questions:

Q. 1. What strictures are currently enforced by the various states which make it more difficult to prevent or lessen the impact of bank failures, and which states enforce these strictures?

A: Many states limit or prohibit branch banking and several limit expansion of multibank holding companies. Liberalization of these laws would increase the possibilities that failed or failing banks could be acquired and operated as branches or independent units either through a purchase and assumption or an open bank assistance transaction. We have had a number of cases where we have had to pay off an insured bank because state limits on expansion precluded the possibility of acquisition outright or rendered such a prospect uneconomic, e.g., where the possibility of continuing the operation of a failed or failing bank in a particular community might be economically feasible as a branch but not practical as a separately capitalized institution. Some states permit branching or multibank acquisitions only as part of a failed bank situation, but not to avoid failure. We are attaching a list of the states with these various limitations. (Attachment # 1)

Most states place depositors on a par with general creditors in liquidating the assets of a failed bank. Parties with contingent claims are considered possible general creditors as well. Very often in these states, it is difficult in a failing bank situation to assess the dollar volume of contingent claims and hence the potential liability the FDIC must assume in order to effect a purchase and assumption transaction. In addition, the greater the volume of such contingent claims, the more difficult it is to satisfy the "cost test" under the FDI Act. Under this test, the FDIC by law can effect a purchase and assumption transaction only where the cost to the FDIC is less than the cost of liquidating the failed bank.

Q. 2. Conversely, what types of provisions should be enacted by the states which would help to prevent or lessen the impact of bank failures, and which states have adopted these type of provisions?

Please supply to this Committee for the hearing record, F.D.I.C.'s response and position on the above two issues. Also, please supply any additional policy statements that F.D.I.C. has made or plans to make on the subject of bank merger, consolidation, or other state policy actions that might be taken to strengthen our nation's banking system.

A: Widespread enactment of depositor preference laws among the states would be most helpful. This is needed on the Federal level as well as with regard to nationally chartered banks. Depositor preference laws would enable the FDIC to ignore the claims of general creditors, including contingent claimants, in meeting the "cost test" under the FDI Act and increase the likelihood that more purchase and assumption transactions can be arranged. Below is a current listing of states with depositor preference laws.

There is a need for the states to continue to open their borders to possible out-of-state acquirors of failed or failing banks, particularly for possible acquirors of larger distressed banks.

In a similar vein on the Federal level, there is a need to extend and broaden the interstate provision of the Garn-St Germain Act to include "failing" as well as failed banks and multibank holding companies where a bank representing a significant share of the holding company's assets is in danger of failing. A reduction in the size limitation to $250 million would be helpful as well. Attached is a copy of an April 8 joint letter from the heads of the three bank regulatory agencies addressing this issue. (Attachment # 2).

There is also a need to grant the FDIC conservatorship powers to provide more time to dispose of failing banks and pass more assets to acquiring institutions.

Finally, there is a need to authorize the FDIC to own stock in an institution for a limited period to permit it to reposition and sell a large failed bank.

We believe the changes suggested will go a long way towards minimizing the disruptions and costs of bank failures both to the communities directly affected and the FDIC.

DEPOSITOR PREFERENCE STATES

Georgia
Hawaii
Idaho
Indiana
Iowa
Kansas
Louisiana
Montana (Deposits and book liabilities are equal.)
Nebraska
Oklahoma
Oregon
Texas
Utah
Virginia
West Virginia

Preference does not apply to national banks.

STATE LAW PROVISIONS GOVERNING

STATE	BRANCHING Statewide Limited Unit	HOLDING COMPANY EXPANSION Multi bank holding company permitted?	SPECIAL PROVISIONS ON FAILING BANKS
Alabama	S	Yes	No
Alaska	S	Yes	No
Arizona	S	Yes	Yes
Arkansas	L	Yes	No
California	S	Yes	No
Colorado	U	Yes	No
Connecticut	S	Yes	No
Delaware	S	Silent	No
D.C.	S	Yes	No
Florida	S	Yes	No
Georgia	L	Yes	No
Hawaii	S	Yes	No
Idaho	S	Yes	Yes
Illinois	L	Yes	Yes[1]
Indiana	L	Yes	Yes[2]
Iowa	L	Yes	No
Kansas	L	Yes	No
Kentucky	L	Yes	Yes[3]
Louisiana	L	Yes	No
Maine	S	Yes	No
Maryland	S	Yes	No
Massachusetts	S	Yes	No
Michigan	L	Yes	No
Minnesota	L	Yes	Yes(Savings bnks only)
Mississippi	L	No	No
Missouri	L	Yes	No
Montana	U	Yes	No
Nebraska	S	Yes	No
Nevada	S	Yes	No
New Hampshire	L	Yes	No
New Jersey	S	Yes	No
New Mexico	L	Yes	No
New York	S	Yes	No
North Carolina	S	Yes	No
North Dakota	U	Yes	No
Ohio	L	Yes	Yes
Oklahoma	L	Yes	No
Oregon	S	Yes	Yes[2-4]
Pennsylvania	L	Yes	No
Rhode Island	S	Yes	No
South Carolina	S	Yes	No
South Dakota	S	Yes	No
Tennessee	L	Yes	No
Texas	U	Yes	No
Utah	S	Yes	Yes[2]
Vermont	S	Yes	No
Virginia	S	Yes	No
Washington	S	Yes	Yes
West Virginia	L	Yes	No
Wisconsin	L	Yes	No
Wyoming	U	Yes	No

1 - May acquire banks with liquidity problems and total assets over $1B.
2 - Geographic limitation.
3 - Acquiring bank may not have more than 3 acquisitions per year and cannot already control 15% of domestic deposits in the state.
4 - May acquire failing banks with total assets of $100M or more.

Attachment # 1

Amended 2-26-86

INTERSTATE BANKING

	Legislation		Reciprocity Required	Failing Bank Provision		
State	Date Passed	Date Effective	Y/N	("X")	States Included	Comments
Alaska		7-1-82	N		Nationwide	Entry by BHCs through acquisition
Arizona		10-1-86 8-7-85*	N	X	Nationwide	Entry by BHCs or banks through acquisition or merger until 7-1-92; then also by de novo. Banks chartered after 5-31-84 protected from takeover. FAILING BANK PROVISION: Out-of-state BHCs nationwide allowed to acquire failing Arizona banks as of 1-1-86
California						Bill Pending - Either Nationwide or Regional, both reciprocal.
Connecticut		6-8-83	Y		Regional - 5 states Maine, Massachusetts, New Hampshire, Rhode Island and Vermont	Entry by BHCs-
District of Columbia		Unknown	Y		Regional - 11 states Alabama, Florida, Georgia Louisiana, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia	Details to be developed.
Florida		7-1-85	Y		Regional - DC and 11 states Alabama, Arkansas, Georgia, Louisiana, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, Virginia and West Virginia	Entry by BHCs. Bank to be acquired must have been in existence for 5 years

State	Legislation		Reciprocity Required	Failing Bank Provision	States Included	Comments
	Date Passed	Date Effective	Y/N	("X")		
Georgia		7-1-85	Y		Regional - 9 states Alabama, Florida Kentucky, Louisiana Mississippi, North Carolina, South Carolina Tennessee and Virginia	Entry by BHCs. Bank to be acquired must have been in existence for 5 years
Idaho		7-1-85 7-1-85*	Y	X	Regional - 6 states Montana, Nevada, Oregon Utah, Washington and Wyoming	Entry by BHCs through acquisition. FAILING BANK PROVISION: Out-of-state BHCs nationwide allowed to acquire failing Idaho banks
Illinois	11-25-85	7-1-86 6-28-84*	Y	X	Regional - 6 states Kentucky, Indiana, Iowa, Michigan, Missouri and Wisconsin	Entry by BHCs or banks through acquisition or merger. FAILING BANK PROVISION: Out-of-state BHCs nationwide allowed to acquire failing Illinois banks with liquidity problems and TA over $1 billion
Indiana		7-1-85 7-1-85*	Y	X	Regional - 4 states Illinois, Kentucky, Michigan and Ohio	Entry by BHCs effective 7-1-85 but acquisitions not allowed until 1-1-86. Indiana banks may avoid acquisition by "opt out" option. BHC share of market cannot exceed 10% of all deposits in 1985, 11% in 1986, and 12% in 1987. FAILING BANK PROVISION: Allows BHCs in the four listed states to acquire failing Indiana banks if reciprocal banking agreements exist

State	Legislation		Reciprocity Required Y/N	Failing Bank Provision ("X")	States Included	Comments
	Date Passed	Date Effective				
Kentucky		7-13-84 7-13-84*	Y	X	Regional - 7 states Illinois, Indiana, Missouri, Ohio, Tennessee, Virginia. Nationwide entry by BHCs on 7-13-87.	Entry by BHCs. Nationwide entry by BHCs on 7-13-87. FAILING BANK PROVISION: Out-of-state BHCs nationwide allowed to acquire failing Kentucky banks with restrictions: (1) not more than 3 acquisitions in a year; (2) acquiring organization cannot already control 15% of (domestic) deposits in the state
Maine		10-1-75	N		Nationwide	Entry by BHCs through acquisition. Reciprocity requirement ended 2-2-84
Maryland		7-1-85	Y		Regional - DC and 3 states Delaware, Virginia and West Virginia.	Entry by BHCs. Banks to be acquired must be at least 4 years old. After 6-30-87, an additional 11 states included - Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, Pennsylvania, South Carolina and Tennesse
Massachusetts		7-1-83	Y		Regional - 5 states Connecticut, Maine, New Hampshire, Rhode Island, and Vermont.	Entry by BHCs or Banks
Michigan	12- -85	7-1-86	Y		Regional - 5 states Illinois, Indiana, Minnesota, Ohio and Wisconsin	Entry by BHCs or banks through acquisition until 10-10-88, then converts to nationwide. Approval of interstate transactions will be subject to safety and soundness considerations and CRA ratings of parties involved. Also must comply with Michigan 18% usury ceiling.

Amended 01-27-86

INTERSTATE BANKING

State	Legislation Date Passed	 Date Effective	Reciprocity Required Y/N	Failing Bank Provision ("X")	States Included	Comments
Minnesota		1981*		X		Bill pending - Regional reciprocal. FAILING BANK PROVISION: Applies only to failing savings banks. Allows out-of-state BHCs nationwide to acquire failing Minnesota savings banks
Mississippi						Bill pending - Allow statewide and interstate banking in 1988 (100 mile branching limit)
Missouri						Bill pending - Regional reciprocal - 8 states Illinois, Kentucky, Tennessee and 5 others
Nevada	6-13-84	7-1-85	Y		Regional - 11 states Alaska, Arizona, Colorado, Hawaii, Idaho, Montana, New Mexico, Oregon, Utah, Washington and Wyoming.	Entry by BHCs through acquisitions only until 7-1-90, then also by de novo. Banks to be acquired must have been in existence for five years. On 12-31-88 BHCs nationwide will be allowed to acquire Nevada banks. Interstate branching from banks nationwide is allowed into Nevada counties with population less than 100 thousand
New Jersey						Bill pending - Regional (reciprocal - DC and 13 states Tennessee, Missouri, West Virginia, Pennsylvania, Delaware, Maryland, Virginia, Ohio, Illinois, Kentucky, Indiana, Wisconsin and Michigan) Bill would become active after three states reciprocate.
New York		6-28-82	Y		Nationwide	Entry by BHCs through acquisition or de novo
North Carolina		7-1-85	Y		Regional - DC and 12 states Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana Maryland, Mississippi, South Carolina, Tennessee, Virginia and West Virginia.	Entry by BHCs

OFFICE OF THE COMPTROLLER OF THE CURRENCY
FEDERAL DEPOSIT INSURANCE CORPORATION
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

April 8, 1986

The Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance,
and Urban Affairs
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman St Germain:

We are writing to express our joint request that the Congress extend and liberalize the emergency acquisition provisions of the Garn-St Germain Depository Institutions Deregulation Act of 1982. This legislation, which now provides for interstate acquisitions of failed banks with assets of $500 million or more, will expire on April 15, 1986.

The emergency acquisition provisions have been most useful in broadening the available range of solutions in dealing with problem banks. Application of these provisions has resulted in major savings for the insurance fund at a crucial time. We believe that, particularly in present circumstances, these provisions should be extended, some of the limitations in their use removed and their scope broadened.

The existing statutory provisions do not provide for the situation where a failing bank is an integral part of a larger banking organization. Use of the statute in these situations requires dismemberment of existing, established bank holding company systems with potentially disruptive effects in the local community and the banking system more generally. In addition, by failing to provide for acquisition of affiliated banks within a holding company structure or the holding company itself or for future expansion in the state, existing law places the acquired banking organization at a severe competitive disadvantage in states that limit geographic bank expansion other than through a holding company.

Moreover, the existing statutory provisions require that a bank have failed in order to be eligible for

Attachment # 2

out-of-state acquisition. By requiring the FDIC to wait until a bank actually fails, the FDIC's options are circumscribed and the costs to the insurance fund are materially increased since, once a bank fails, its value to a potential acquiror may be substantially diminished. In our view, it would be more constructive and less destabilizing to the local community and the banking system generally to authorize bank management and the regulators to act if a bank is clearly in danger of closing.

Finally, in order to be eligible for out-of-state acquisition, a failed bank under the current provision must have assets of at least $500 million. This limitation does not address situations involving smaller banks which are of significant size and importance in the local or state banking community that they serve, but whose capital needs cannot be supplied by in-state organizations.

Based on our experience during the past four years and on the current outlook, four specific changes appear desirable to address the weaknesses in the emergency legislation we have described.

First, we recommend that Congress permit the out-of-state acquisition of failing banks, as well as of failed banks. Second, an option should be made available for out-of-state acquisition of the bank subsidiaries of a bank holding company or the holding company itself when the failing bank (or banks) exceeds the statutory size threshold and represents a sizeable part of the holding company system, and the appropriate chartering authority certifies the bank (or banks) as being in danger of closing. Third, an out-of-state acquirer should be afforded the same expansion rights as an in-state organization. Fourth, we recommend that the asset size of banks eligible to be acquired pursuant to the emergency provisions be reduced from $500 million to at least $250 million.

It seems unavoidable that over the foreseeable future, there will continue to be situations in which banks will have problems so severe that they will be unable to continue to operate without an infusion of additional capital and fresh management. It is thus vital that banking supervisors have adequate tools to deal with such situations quickly and effectively in order to minimize their impact on local communities or regions and to avoid repercussions on the banking system generally.

The Honorable Fernand J. St Germain
Page 3

Accordingly, we strongly recommend that the emergency acquisition provisions of the Garn-St Germain Act be extended with the strengthening provisions we have recommended. We will be forwarding proposed legislation to implement our recommendations in the near future.

Sincerely,

L. Wm Seidman Paul A Volcker

Robert L. Clarke L. William Seidman Paul A. Volcker

L. WILLIAM SEIDMAN, Chairman
FDIC
Questions from Senators Zorinsky, Boren, Exon and Harkin

Q.1. Living Expenses for Farmers with Loans Held by the FDIC

When the FDIC owns a farmer's loans, all proceeds from the sale of crops or other assets are controlled by the FDIC. Current regulations for disbursing these funds for the farmer's living expenses are not reliable or humane. We need specific guidelines for FDIC field personnel to ensure that living expenses are provided reasonably, reliably and quickly. Why is the FDIC willing to lose $1.3 billion for a large bank, but is so begrudging when providing money to meet a farmer's living expenses? How soon can we expect specific guidelines for FDIC field personnel to redress this problem?

A: Attached in response is a copy of our letter of March 27 to Senator Zorinsky that addresses these issues. (Attachment # 3)

Q.2. Side Agreements Which the FDIC Does Not Honor

Why can't the FDIC modify its examination procedures so that side-agreements are evaluated to determine whether the FDIC would honor them? Until examination procedures are changed, why can't a campaign be launched to inform farm belt banks of the FDIC's requirements for honoring side-agreements? How long would it take to send out such notices?

A: As a matter of examination practice, our examiners do consider side agreements of which they are aware in assessing the collectibility of loans in an open and operating bank. Of course, these agreements frequently are not available to our examiners or are rewritten.

In order to help assure that side agreements are honored when an insured bank fails, we are prepared to issue a bank letter reminding insured banks of the loan documentation necessary to meet the current requirements of section 13(e) of the FDI Act. Such a bank letter may also have the salutary effects of helping to facilitate loan review by our examiners and bringing to the attention of senior management and the board of directors side agreements made by loan officers that might otherwise go unreported.

Our examiners receive copies of all bank letters and are bound by the policy directives set forth in such letters in their loan reviews and in the overall conduct of examinations.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

OFFICE OF THE CHAIRMAN

March 27, 1986

Honorable Edward Zorinsky
United States Senate
Washington, D.C. 20510

Dear Senator Zorinsky:

This letter is in response to your March 10, 1986 letter with regard to bank failures and the agriculture economy. You asked that prompt consideration be given to your concerns.

I am taking the liberty of distributing your letter to our six Division of Liquidation Regional Directors for two purposes: (1) to make them fully aware of your concerns and those of your constituents, and (2) to request that they reemphasize, to their personnel, the importance of being sensitive to the effect their actions have on the community at large.

When the FDIC is appointed receiver of a failed bank, it becomes the FDIC's duty to maximize the return from acquired assets of the failed institution. The FDIC honors the terms and conditions of the loans as written and it is the borrower's responsibility to pay off the note(s) which he/she has executed.

There are situations where an obligor cannot pay off a loan in full because of conditions such as unavailable refinance funds, poor cash flows or inadequate collateral to secure other financing. In these instances, the FDIC evaluates each situation on a case by case basis. The FDIC can, if supported by proper financial information from the debtor, enter into a workout agreement, restructure a loan, and make a compromise settlement of the debt. We sympathize with the hardship endured by some individuals or businesses; however, by law we must maximize the return on all loans that are acquired from failed institutions.

FDIC, Division of Liquidation policy indicates that the FDIC will generally not advance money for anything other than for the protection of collateral since we are not a lending institution or agency. When additional funds are requested for the protection of crops, the option may exist to sell livestock instead of advancing funds. Additional alternatives to advancing funds include subordinating to another creditor and entering into nondisturbance agreements when another party is willing to lend to the farmer.

The advance of funds or release of proceeds for living expenses may be considered on a case by case basis in those instances where it does not reduce the ultimate collection for the FDIC.

Attachment # 3

Honorable Edward Zorinsky
Page 2

The period of time required to determine whether funds can be released varies depending upon the availability of the necessary information to analyze the debtors collateral, value of assets and financial condition. After approval by the Bank Liquidation Specialist-In-Charge of the field site, checks for Nebraska liquidations are issued, as expeditiously as possible, through the Omaha Consolidated Office.

In a further effort to do everything possible within the confines of the law, I am asking by way of the distribution of this letter to the Regional Directors, that they together with their counsel, reevaluate the release of proceeds guidelines to see: (1) if the release of proceeds process can be expedited; (2) whether there is any feasible and legal means to further accomodate debtors desiring the release of proceeds for living expenses; and, (3) if present guidelines need to be clarified, if #2 is not possible, to make sure they are uniformly applied. Any recommendations, from the Regional Directors, should be forwarded to the Associate Director (Credit), Washington, D.C., by April 15, 1986, for review, consideration and implementation if appropriate.

I am enclosing, for your information, a copy of an October 17, 1985 agreement entered into by the Farmers Home Administration and the Federal Deposit Insurance Corporation.

If we may provide additional information, please let me know.

With best wishes.

Sincerely,

L Wm Seidman

L. William Seidman
Chairman

Enclosure

cc: Associate Director (Credit) - Mr. Seelig
Atlanta Regional Director - Mr. Dudley
Chicago Regional Director - Mr. Beshara
Dallas Regional Director - Mr. Newton
Kansas City Region Director - Ms. Sullivan
New York Regional Director - Mr. Martinelli
San Francisco Regional Director - Mr. Kelly

Agreement

The Federal Deposit Insurance Corporation ("FDIC") and the Farmers Home Administration ("FmHA") have a mutual interest in maintaining the creditworthiness of farmers who have outstanding obligations with insured banks which have been closed and for which the FDIC is acting as receiver or liquidator of assets. Accordingly, the FDIC, in its separate capacity as receiver or liquidator of assets for a closed insured bank, and FmHA agree as follows:

1. The FDIC, as receiver or liquidator of assets of a closed insured bank which had a substantial number of farm-related credits, shall notify the FmHA which shall send into the affected area a "Farm Credit Relief Support Team" (support team) consisting of five or more trained FmHA loan officers. The FDIC will assist in arranging for reasonable office space and equipment for the support team. Prior to any FmHA employee reviewing a loan file of the closed bank, the FDIC shall attempt to secure from the debtor involved such releases or waivers as may be required by the Right to Financial Privacy Act (12 USC 3404) or other relevant statutes. The waiver form shall be substantially in the form of Attachment "A" hereto. Such releases or waivers are condition(s) precedent to the FmHA reviewing a debtor's file.

2. The FDIC shall provide to the FmHA support team members all available financial information and shall use its best efforts together with FmHA to obtain such other information deemed necessary and appropriate to make a credit decision. The determination to issue a Notification of Intent to Guarantee (Attachment "B") shall be within the sole discretion of the FmHA.

3. If the review and credit analysis allow FmHA to determine that a debtor meets FmHA's basic eligibility and other requirements for an FmHA guaranteed loan for 1986 farm operating needs, then FmHA will issue a "Notification of Intent to Guarantee." Said notification will evidence FmHA's intent to issue a guarantee to a qualified lending institution upon the terms and conditions set forth in the notification, and in accordance with all applicable regulations and statutes covering FmHA's guaranteed loan programs. The FDIC is authorized to deliver said notification to any lending institution eligible to participate as an FmHA guaranteed lender. The support team members shall be authorized by FmHA to execute said notification on behalf of FmHA. All Notifications of Intent to Guarantee are to be issued subject to availability of funds.

Executed this 17th day of October, 1983.

Vance L. Clark
Administrator
Farmers Home Administration

James A. Davis
Director, Division of Liquidation
Federal Deposit Insurance Corporation

Amended 2-26-86

INTERSTATE BANKING

State	Legislation Date Passed	 Date Effective	Reciprocity Required Y/N	Failing Bank Provision ("X")	States Included	Comments
Ohio		Unknown 10-17-85*	Y	X	Regional - DC and 13 states Deleware, Illinois, Indiana Kentucky, Missouri, Michigan, Maryland, New Jersey, Pennsylvania, Tennessee, Virginia, West Virginia and Wisconsin	Entry by BHCs. FAILING BANK PROVISION: Allows out-of-state BHCs nationwide to acquire failing Ohio banks if the Superintendent waives regional reciprocal and percentage of deposit limitations. Nationwide trigger 10-17-89.
Oregon		7-1-86 3-12-85*	N	X	Regional - 8 states Alaska, Arizona, California, Hawaii, Idaho, Nevada, Utah, and Washington.	Entry by BHCs or banks through acquisition. Oregon banks must have been in existence for three years. FAILING BANK PROVISION: BHCs in the eight listed states allowed to acquire failing Oregon banks of TA $100 million or more
Pennsylvania						Bill pending - Regional (Reciprocal) - DC and 7 states - Ohio, New Jersey, Maryland, Kentucky, Virginia, West Virginia, and Delaware Nationwide Trigger.
Rhode Island		7-1-84	Y		Regional - 5 states Maine, Massachusetts, New Hampshire, Vermont	Entry by BHCs. Nationwide on 7-1-86
South Carolina		7-1-86	Y		Regional - DC and 12 states Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Tennessee, Virginia and West Virginia	Entry by BHCs
South Dakota		Unknown	N		Nationwide	Details not available
Tennessee		7-1-85	Y		Regional - 13 states Alabama, Arkansas Florida, Georgia, Indiana Kentucky, Louisiana, Mississippi, Missouri, North Carolina, South Carolina, Virginia and West Virginia	Entry by BHCs; however, language and procedural requirements make acquisitions in a "Failing Bank" scenario impractical (re: Carroll Shifflett memo of 7-23-85).

INTERSTATE BANKING

State	Legislation Date Passed	 Date Effective	Reciprocity Required Y/N	Failing Bank Provision ("X")	States Included	Comments
Texas						Bill Pending
Utah	1-21-86*	4-17-84 4-13-84* 1-21-86*	Y	X	Regional - 11 states Alaska, Arizona, Colorado Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Washington and Wyoming	Entry by BHCs through acquisition. Nationwide acquisition by BHCs to be effective 12-31-87 FAILING BANK PROVISION: 4-13-84- Out-of-state banks and BHC in the eleven listed states allowed to acquire failing Utah banks (Reciprocity not required). 1-21-86 - BHCs Nationwide allowed to acquire problem banks (Reciprocity not required)
Virginia		7-1-85	Y		Regional - DC and 12 states Alabama, Arkansas, Florida Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, South Carolina, Tennessee and West Virginia	Entry by BHCs
Washington		7-1-87 4-25-83*	Y	X	Nationwide	Entry by BHCs or banks through acquisition. Banks to be acquired must be at least three years old. FAILING BANK PROVISION: Out-of-State BHCs nationwide allowed to acquire failing Washington banks
West Virginia						Bill pending - Regional reciprocal, with Nationwide trigger
Wisconsin						Bill pending - Regional reciprocal

* - Failing Bank Provision

Amended 01-27-86

BANKERS' ASSOCIATION FOR FOREIGN TRADE

1600 M Street N.W., Seventh Floor, Washington, D.C. 20036
Tel: (202) 452-0952

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WASHINGTON, D.C.

EXECUTIVE DIRECTOR
MARY CONDEELIS
WASHINGTON, D.C.

October 10, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
& Urban Affairs
United States Senate
Dirksen Senate Office Bldg.
Room SD-534
Washington, D.C. 20510

Re: Hearings on Deposit Insurance Reform

Dear Chairman Garn:

The Bankers' Association for Foreign Trade ("BAFT") is a trade association of money-center, regional and smaller banks dedicated to promoting international trade and finance. Its 135 voting members comprise virtually all U.S. banks actively involved in international banking and trade finance.

In connection with the Banking Committee's recent and continuing hearings on possible reforms to the deposit insurance system, we note that, at several points, the issue has been raised of whether foreign branch deposits of U.S. banks should be subject to FDIC premium assessments. Unfortunately, to date, the few witnesses who have raised the issue have done so either in a conclusive or cursory manner. As was recently suggested by Chairman Volcker of the Federal Reserve in his written statement of September 11, 1985 before the Committee, this issue is a complex and difficult one and a full and careful assessment must be made of the pros and cons involved. In this regard, BAFT has prepared a statement on this issue which is enclosed and which addresses the major public policy detriments which we believe would result from FDIC assessments on foreign branch deposits. We respectfully request that this statement be included in the record of the hearings.

FOSTERING SOUND INTERNATIONAL BANKING SINCE 1921

In BAFT's view, extending FDIC premiums to cover foreign branch deposits of U.S. banks is unnecessary from a fairness standpoint and counterproductive from a risk standpoint. The only certain result is that the added costs of assessments would make it more difficult for U.S. banks to compete abroad and to finance the international needs of their U.S. customers on a competitive basis. This result is certainly not in the public interest when the U.S. is facing record merchandise trade and balance of payments deficits and when substantial efforts are being made by the Administration and you to reduce barriers to U.S. banks abroad.

Sincerely,

David H. Dorminey
President

DHD/jyh
cc: The Honorable William Proxmire
Ranking Minority Member

All Members of the Senate Committee
on Banking Housing and Urban Affairs

STATEMENT OF THE

BANKERS' ASSOCIATION FOR FOREIGN TRADE

IN OPPOSITION TO PROPOSALS TO IMPOSE FDIC ASSESSMENTS ON FOREIGN BRANCH DEPOSITS OF U.S. BANKS

SUBMITTED TO:

Committee on Banking, Housing and Urban Affairs
United States Senate

October 10, 1985

INTRODUCTION

For fifty (50) years, it has been the public policy of the United States to exclude deposits at foreign branches of U.S. banks from Federal Deposit Insurance Corporation ("FDIC") assessments and coverage. This policy was established in 1935 and reaffirmed by Congress in 1981 when it also exempted deposits at International Banking Facilities ("IBFs") from FDIC assessments and coverage, because the additional costs associated with FDIC assessments would put U.S. banks at a serious disadvantage in competing internationally.

Recently, however, proposals have been made to impose FDIC assessments on foreign branch deposits of U.S. banks as a way of increasing the size of the FDIC fund and of making large money-center banks pay more premiums into the fund. The Bankers' Association for Foreign Trade ("BAFT"), a trade association of 135 U.S. banks actively involved in international banking and trade finance, is strongly opposed to such proposals because they would clearly be detrimental to the foreign trade, economic, and foreign policy interests of the United States and would likely increase systemic risks to the U.S. and international banking systems.

ASSESSMENT OF FOREIGN BRANCH DEPOSITS IS UNNECESSARY

Proposals to include foreign branch deposits in the FDIC assessment base have generally been based on either of two premises.

First, it has been suggested that assessing foreign branch deposits of U.S. banks would be one way of increasing the size of the FDIC fund. However, officials of the FDIC have consistently stated that the size of the FDIC fund is adequate. As of July 31, 1985, the FDIC had assets of $23.8 billion and an insurance fund of over $18.8 billion. Simply put, there has been no showing to date that the FDIC needs additional funds, whether derived from assessment of foreign branch deposits or other sources.

Second, it has been suggested that assessment of foreign branch deposits is "fair" because such deposits are de facto insured by the FDIC. Because section 3(l) of the FDIC Act expressly excludes foreign branch deposits from FDIC insurance, such suggestion has apparently been based on the premise that any bank having foreign branches is "too big to fail" and its foreign depositors would thus be made whole by the FDIC. We believe that premise is wrong on several counts.

Firstly, the premise that some banks are "too big to fail" is merely a hypothesis: it is neither proven fact nor established public policy. As the Committee's hearings have already demonstrated, opinions differ sharply over the validity of this premise. In this connection, the Committee has already received a number of thoughtful suggestions from bank trade associations and other witnesses for approaches to dealing with bank failures which would ensure that no bank is too big to fail, i.e., that all banks regardless of size would be treated equally in a failure situation. We note further that, at his recent confirmation hearing, Mr. Seidman stated that (if confirmed as Chairman of the FDIC) he would like to come up with a plan "that makes it clear that all banks, no matter what the size, can be treated in the same way under similar circumstances."[1] Even Chairman Isaac, who has supported including foreign branch deposits in the FDIC assessment base, admitted in testimony before the Committee that if foreign branch deposits could be excluded from (de facto) coverage then there would be no reason to assess them.[2]

Secondly, the "too big to fail" premise begs the obvious question of which banks are "too big to fail." Who draws this line and where is it drawn? Federal Reserve figures indicate that 166 U.S. banks have foreign branch operations. If foreign branch deposits were assessed, would that mean that all such 166 banks would be "too big to fail"? If not, would it be fair to require banks to pay assessments on their foreign branch deposits when, in fact, their foreign branch depositors would not be covered by the FDIC?

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[1] Transcript of September 19, 1985 at 24.

[2] Transcript of July 23, 1985 at 23.

Lastly, the "too big to fail" concept turns the basic purpose of the FDIC on its head. Under such concept, instead of being an insuror of U.S. retail deposits, the FDIC would become an implied guarantor of the worldwide operations of U.S. banks. We respectfully submit that such a radical change in the FDIC's mission has implications far beyond the assessment of foreign branch deposits.

ASSESSMENT OF FOREIGN BRANCH DEPOSITS IS DETRIMENTAL TO BROADER PUBLIC POLICY INTERESTS OF THE U.S.

Each time Congress has looked at the issue of whether foreign branch deposits should be assessed and insured -- in 1935 and again in 1981 in connection with IBFs -- it has concluded that assessment of such deposits would seriously harm the ability of U.S. banks to compete in international markets, and that such harm outweighed any marginal increases to the FDIC fund.

Given this longstanding public policy, those who may propose assessing foreign branch deposits must bear the burden of demonstrating that this change would not seriously damage the competitive position of U.S. banks abroad. From our standpoint as a trade association of international bankers, the competitive reasons which led to the exemption of foreign branch deposits from FDIC assessments are even more compelling today than they were 50 years ago when the original exemption was enacted.

First, international trade is much more important to the U.S. economy today than it was fifty years ago. International markets are also much more competitive today than they were fifty years ago, as U.S. businesses and banks find themselves competing with an ever-growing list of highly sophisticated and sometimes government-owned or supported foreign businesses and banks.

Second, services are now the most important segment of the U.S. economy, and are the key to the future competitiveness of the U.S. in international markets. The Trade in Services Study, which was submitted by the United States to the General Agreement on Tariffs and Trade ("GATT") in December 1983, stated that services, including government, now account for two-thirds of U.S. gross national product and 70 percent of U.S. employment. The United States is the largest exporter of services ($34.9 billion in 1980), and it is believed the amount of U.S. service sector exports are much greater than those reported. In this connection, in a study done for the

Departments of State and Commerce and Office of U.S. Trade Representative, an independent consultant estimated that foreign revenues from the international business operations of the U.S. banking industry in 1980 were $9.1 billion (on a net basis), making banking the second largest U.S. service sector internationally in terms of revenue.

Third, U.S. banks' share of world banking assets has decreased markedly over the past decades, as competition from large foreign banks has intensified. After the end of World War II, U.S. banks held approximately 50% of the assets of the world's 100 largest banks. By the end of 1983, the percentage had declined to 14%.

Lastly, given a mechandise trade deficit approaching $150 billion and a growing balance of payments deficit, now is not the time to take actions which would make it more difficult for U.S. banks and their customers to compete abroad.

REDUCED U.S. INTERNATIONAL COMPETITIVENESS

U.S. banks play a double role in American trade competitiveness. There is a direct role, in that service exports are extremely significant to the overall U.S. balance of payments and help to compensate for the widening U.S. merchandise trade deficit. As previously noted, banking is the second largest U.S. service sector internationally in terms of revenue. In addition, U.S. banks finance U.S. exporters.

Should U.S. banks' ability to function in international markets be damaged, so will their ability to service American exports.

There is no doubt that FDIC assessments would put U.S. banks at a serious competitive disadvantage in international markets. Intense competition in foreign markets has created spreads which are relatively thin, especially in such important operations as interbank placements. FDIC assessments would result in a tax of 6-8 basis points on all international deposit transactions.[1] U.S. banks would not be able to pass this tax on to their customers because, since their major competitors are foreign banks which do not bear this cost, passing it through would make U.S. banks' prices noncompetitive. This added tax would simply be another disadvantage imposed on U.S. banks in their efforts to compete with foreign banks that frequently operate under foreign government ownership or support with lower capital ratios, lower effective reserve requirements, and generally fewer operating constraints. In this connection, U.S. banks have been losing market share and are now second to Japanese banks in the international market. See Exhibit A. Given the thinness of margins in the Euromarkets -- frequently as low as 25-40 basis points -- it is clear that even a 6-8 basis points added cost could make a critical difference in many transactions.

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[1] The current FDIC assessment rate is 1/12 of 1% or 8.3 basis points. Senator Proxmire proposed last year an assessment rate of 1/15 of 1% or 6.7 basis points on all deposits, including foreign branch deposits. While rebates could theoretically reduce these rates, international banking transactions cannot be priced on the basis of future rebates which may or may not occur. In this regard, since 1980, FDIC rebates have varied substantially due to increased bank failures.

The ultimate problem is not simply a loss of business or reduced profits for U.S. banks, developments which, in and of themselves, would hurt the U.S. balance of payments. If U.S. banks are burdened by a special FDIC tax which does not apply to foreign banks, then it becomes more difficult for them to extend competitive international financing to their U.S. customers who must compete for foreign sales against non-U.S. companies financed by non-U.S. banks. The result will be reduced U.S. exports at a time when we are facing a record merchandise trade deficit.

REDUCED LIQUIDITY IN THE EURODOLLAR MARKET

- Access to the Eurodollar market is an important component in U.S. bank liquidity. This market is primarily a wholesale market, and for banks which are active in international lending, it acts as a source of deposits as well as an important tool in the management of interest maturity exposure. Purchases of deposits and of foreign exchange in the Eurodollar market allow banks to hedge and protect themselves from volatility in interest rate and foreign exchange risks. The interbank market endows U.S. banks with maximum flexibility and liquidity -- both of which heighten bank safety by increasing the ability to meet unforeseen needs.

The liquidity of this market has already been attenuated by the impact of international credit problems and increased U.S. bank capital ratios, which have resulted in a reduced level of interbank placing. In 1981, U.S. banks' claims on foreign banks, i.e. liquid Eurodollar deposits, totalled $150 billion: by year-end 1984, this source of liquidity had shrunk by one-third to $100 billion. See Exhibit B. FDIC assessments on foreign branch deposits would exacerbate this diminution in liquidity, as premiums would be assessed on each international deposit transaction -- resulting in fewer transactions and a further decline in overall liquidity (gross turnover in the Eurodollar market today exceeds the net loans and deposits, since a deposit made with one bank may be on-lent through several banks before reaching the ultimate borrower). Less liquidity clearly means less capacity on the part of U.S. banks to manage risk and to support U.S. industry's international financial needs.

SPECIAL DISINCENTIVES TO REGIONAL BANKS

Contrary to conventional wisdom, the impact of FDIC assessments on foreign branch deposits may, in the long run, be more damaging to the international operations of regional banks than money-center banks. While money-center banks would face significant increases in FDIC assessments if foreign branch deposits were covered, such banks may be able to reduce the impact of such assessments through the increased use of foreign subsidiaries and non-deposit funding strategies. Regional banks lack the extensive networks and resources to reduce the impact of FDIC assessments and are thus likely to experience a more direct bottom-line impact on their international earnings. As a result of the thinness of international spreads and higher capital requirements, many regional banks are already cutting back their international activities by closing foreign offices and reducing interbank placements and lending activities. The additional costs associated with FDIC assessments may cause a further retrenchment of regional banks' international activities at a time when they are being encouraged to maintain their crucial role in financing the exports of middle-market and smaller U.S. customers and in lending to the LDCs. A reduced role for regional banks means less U.S. exports, less needed new money for the LDCs, and a further concentration of international lending at the major money-center banks, developments which would be harmful to interests of the U.S. and the world's trading and financial system.

INCREASED RISKS TO THE FDIC FUND AND FOREIGN POLICY COMPLICATIONS

If foreign branch deposits of U.S. banks were to become subject to FDIC assessments, then such deposits would presumably be covered by FDIC insurance, greatly increasing the exposure of the FDIC fund. Even if such deposits were not **de jure** covered, the fact that they were being assessed would create the strong implication of **de facto** coverage by the FDIC. Such **de jure** or **de facto** coverage could result in significant legal problems for the FDIC and in potential foreign policy problems for the U.S. For example, in 1984, the Philippine Treasury exhausted its supply of foreign currency and the government prohibited local banks -- including local branches of U.S. banks -- from repaying dollar deposits upon maturity. With foreign deposits assessed and **de jure** or **de facto** insured by the FDIC, such situations would be open invitations to depositors to sue the local U.S. bank branches and their insurer, the FDIC, to obtain their funds. Similar calls on the FDIC could arise in conjunction with other events (which have occurred) such as foreign government expropriation of U.S. bank branches. These and many other novel legal and supervisory problems could increase risks to the FDIC fund and, in many cases, could cause unwarranted regulatory or foreign policy problems with host country governments.

FOREIGN DEPOSIT ASSESSMENTS ARE INCONSISTENT WITH GREATER RELIANCE ON MARKET DISCIPLINE

Imposition of FDIC assessments on foreign branch deposits would be convincing evidence of a moral and supervisory commitment by the FDIC to stand behind the worldwide operations of U.S. banks. Such a commitment reduces the market discipline which exists today in international funding markets, a discipline which the FDIC wishes to enhance and which is the most effective check on undue risk in banking operations. By weakening market discipline and establishing **de jure** or **de facto** coverage of worldwide operations, FDIC assessments on foreign branch deposits would thus increase, rather than decrease, the systemic risks now faced by the FDIC.

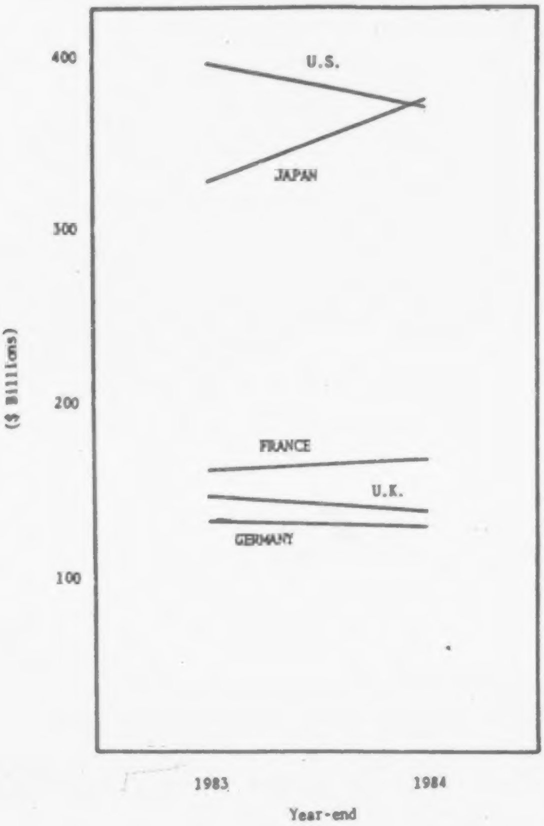
CONCLUSION

Proposals to include foreign branch deposits in the FDIC assessment base are based on a "too big to fail" hypothesis which is unproven, which is unfair to regional and smaller banks, especially with foreign branch operations, and which would entail a radical change in the FDIC's mission. Continued exemption of foreign branch deposits from FDIC assessments is based on a longstanding and sound policy of maintaining the competitiveness of U.S. banks in international markets. A change in this policy to assess foreign branch deposits would result in reduced competitiveness of U.S. banks in foreign markets, reduced U.S. exports, reduced lending to small businesses involved in international activities, reduced lending to the LDCs, reduced competition in international lending among U.S. banks, reduced liquidity in international markets, and reduced market discipline in international banking. While such assessments might provide a small increase in FDIC income, that increase would be dwarfed by increased risks to the FDIC fund, increased systemic risks to the international banking system and increased legal and supervisory problems.

In sum, BAFT believes extension of FDIC assessments to the foreign branch deposits of U.S. banks would be contrary to the public policy interests of the United States.

EXHIBIT A

INTERNATIONAL ASSETS OF BANKS BY COUNTRY OF PARENT BANK



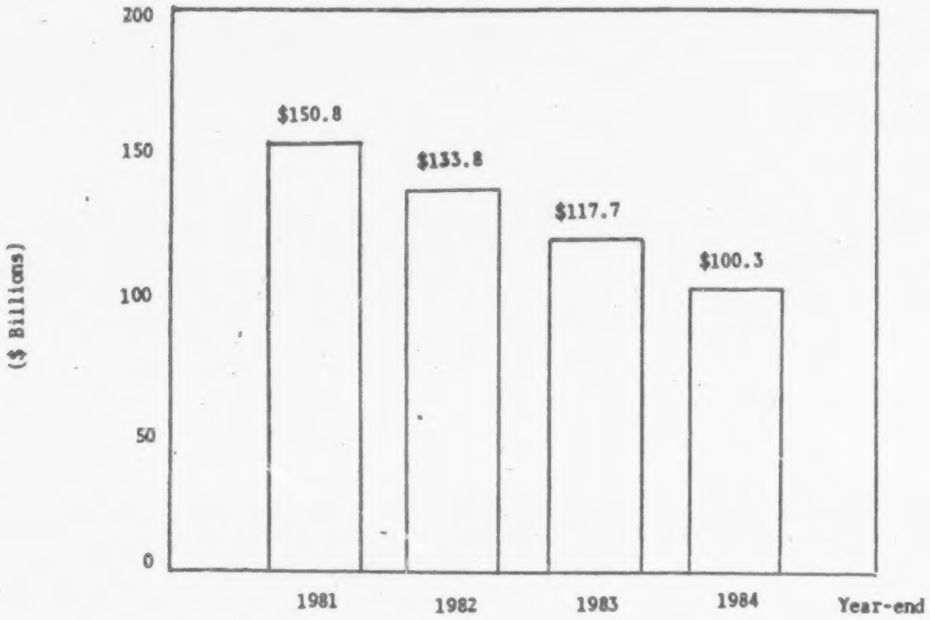
DATA:
(in billions)

	Assets	Market Share	Assets	Market Share
	1983		1984	
U.S.	$393.7	26.4%	$369.5	24.4%
Japan	$326.2	21.9%	$372.1	24.6%
France	$160.8	10.8%	$167.7	11.1%
U.K.	$146.9	9.9%	$137.1	9.1%
Germany	$132.0	8.9%	$129.6	8.6%
All Other	$331.5	22.1%	$335.8	22.2%
TOTAL	$1491.1	100%	$1511.8	100%

SOURCE: BIS, May 10, 1985, "The Nationality Structure of the International Banking Market and the Role of Interbank Operations".

EXHIBIT B

INTERBANK PLACINGS OF U.S. BANKS TO FOREIGN BANKS



DATA:
(in billions)

Year	Placings
1981	$150.8
1982	$133.8
1983	$117.7
1984	$100.3

SOURCE: Federal Reserve Bulletin - ..BLE 3.14

CHICAGO MERCANTILE EXCHANGE

William J. Brodsky
President
Chief Executive Officer
312/930-3300

October 21, 1985

The Honorable Jake Garn
U.S. Senator
Chairman
Committee on Banking, Housing
and Urban Affairs
Washington, D. C. 20510

Dear Senator Garn:

The Chicago Mercantile Exchange appreciates the opportunity to comment on a fundamental concern of our depository insurance system: risk management. Our perspective is one of a leading marketplace for the transfer of risk. Among other financial and agricultural products, this Exchange trades futures contracts on U.S. Treasury bills, Domestic Bank Certificates of Deposit and Eurodollar time deposits. We also trade options on Eurodollar futures. Through these futures and options markets a financial institution can control its interest rate risk.

Our principal comment is that the FDIC and FSLIC should encourage the use of interest rate risk management by banks and savings and loans. By instituting appropriate incentives for these institutions to manage their interest rate risk, federal depository insurance can be protected against perhaps the major source of financial institution risk.

This encouragement by the FDIC and FSLIC should include the following elements: (1) seeking information from banks and savings and loans in a manner that emphasizes that interest rate risk is being monitored; (2) providing training so that on-site examiners can review the merits and mechanics of interest rate risk management with personnel at examined institutions; and, (3) providing an incentive for institution's to manage interest rate risk, such as through premiums or capital requirements that depend on interest rate risk.

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This encouragement is sensible because interest rate risk is readily quantifiable. As was stressed in the FDIC report to the Congress resulting from the Garn-St. Germain Depository Institutions Act of 1982, interest rate risk is without the "subjectivity and inconsistency that impedes or prohibits measurement" of other types of risks.[1] Objective measurement of the riskiness of one institution versus another, at least as to interest rate risk, is possible through a relatively simple reporting system, such as through Call Reports.

Importantly, through financial futures and options, reduction of risk can be accomplished without either impairing the ability of financial institutions to perform their traditional intermediation roles or forcing interest rate risk onto the users of these services. By disposing of risk on an exchange - rather than on customers - customer default risk is also reduced.

Further, since financial futures and options are "marked to market" daily, their use in risk management minimizes the risk of hidden accrued losses that have been the source of large claims on federal insurance funds. Also, the fact that an exchange stands between the parties to a trade insures the financial integrity of the trade and severely limits the potential for a default of one party to have a "domino effect" in the financial industry.

The result of hedging with futures and options markets is easily understood: reduced risk for financial institutions. The result for the depository insurance system if it offered incentives to banks and savings and loans to use futures and options to reduce interest rate risk is likewise easily understood: less risk to the insurance system. The mechanics of using futures and options are less easily understood. The American Banker has prepared a simple yet insightful piece that is both theoretically and factually sound. I offer this pamphlet for inclusion in the record to help illustrate how options and futures can reduce interest rate risk.

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[1] Deposit Insurance is a Changing Environment, Federal Deposit Insurance Corporation, Report to the Congress, April 15, 1983, p. II-13.

The Honorable Jake Garn
U.S. Senator
October 21, 1985
Page Three

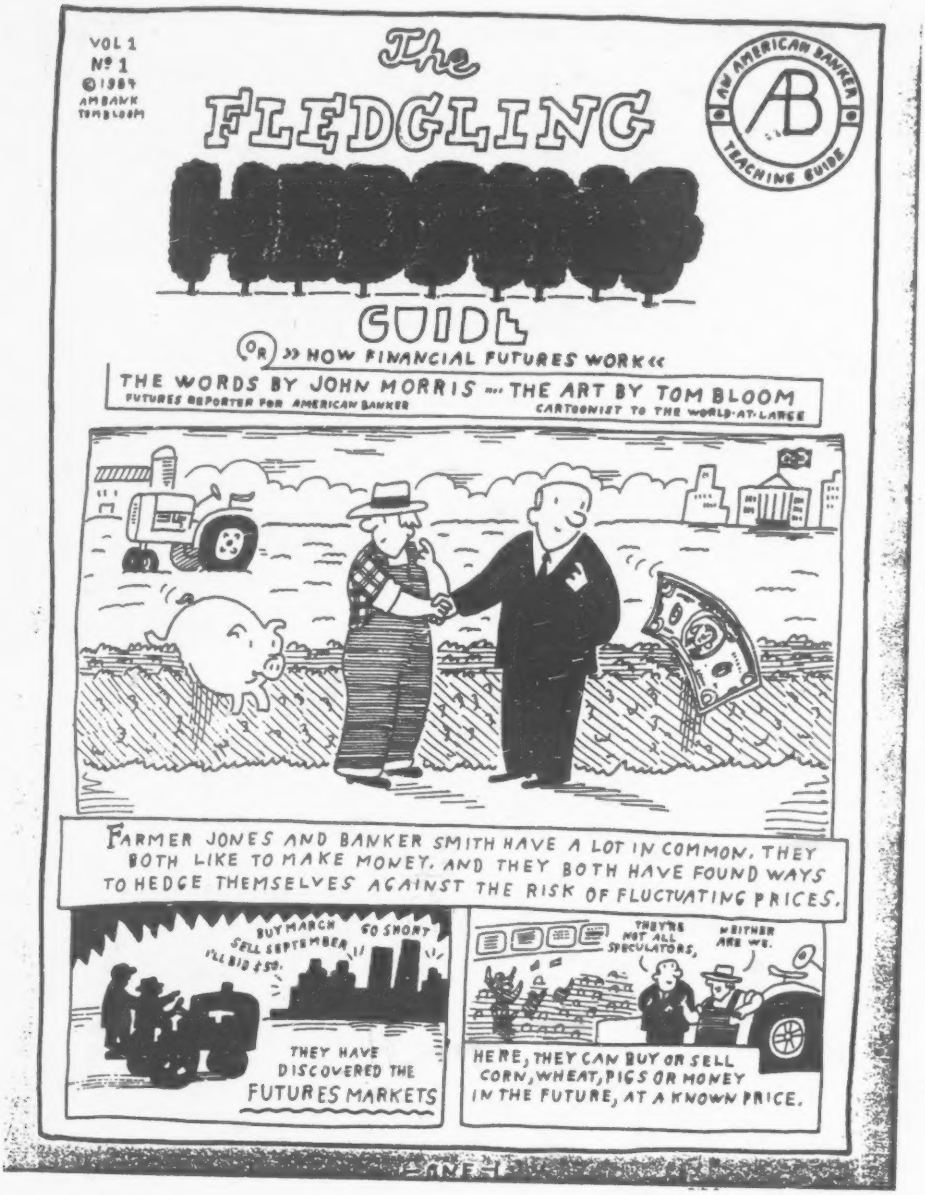
Moreover, the futures and options markets can and do play a critical role in facilitating financial institution management of interest rate risk. The depository insurance systems will be less at risk to the extent the FDIC and FSLIC encourage financial institutions to use the risk management tools available in the futures and options markets. My staff would be pleased to provide additional information on how financial futures and options can be used to reduce risk in financial institutions.

Again, thank you for this opportunity for comment.

Sincerely,

William J Brodsky

WJB:mdt
Enclosure


VOL 1
Nº 1
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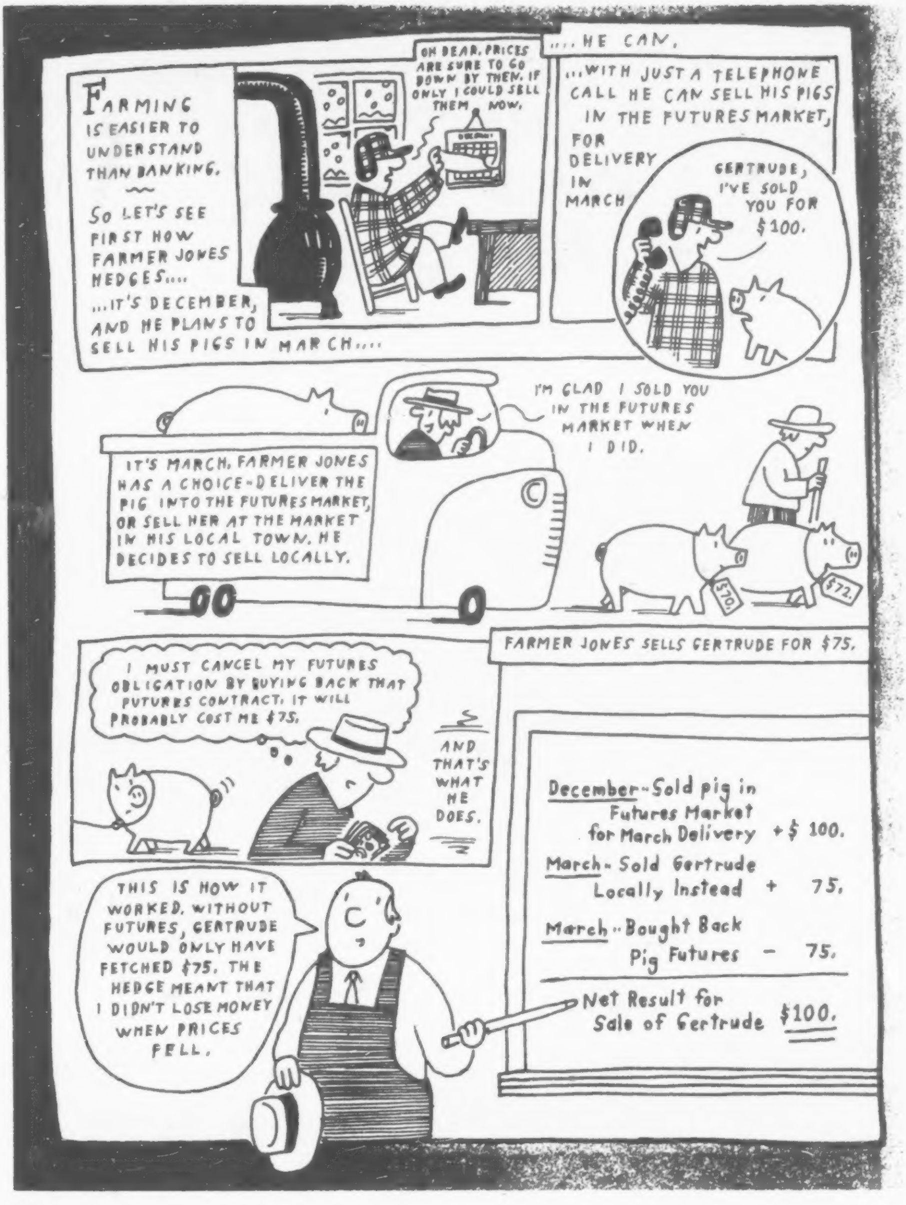
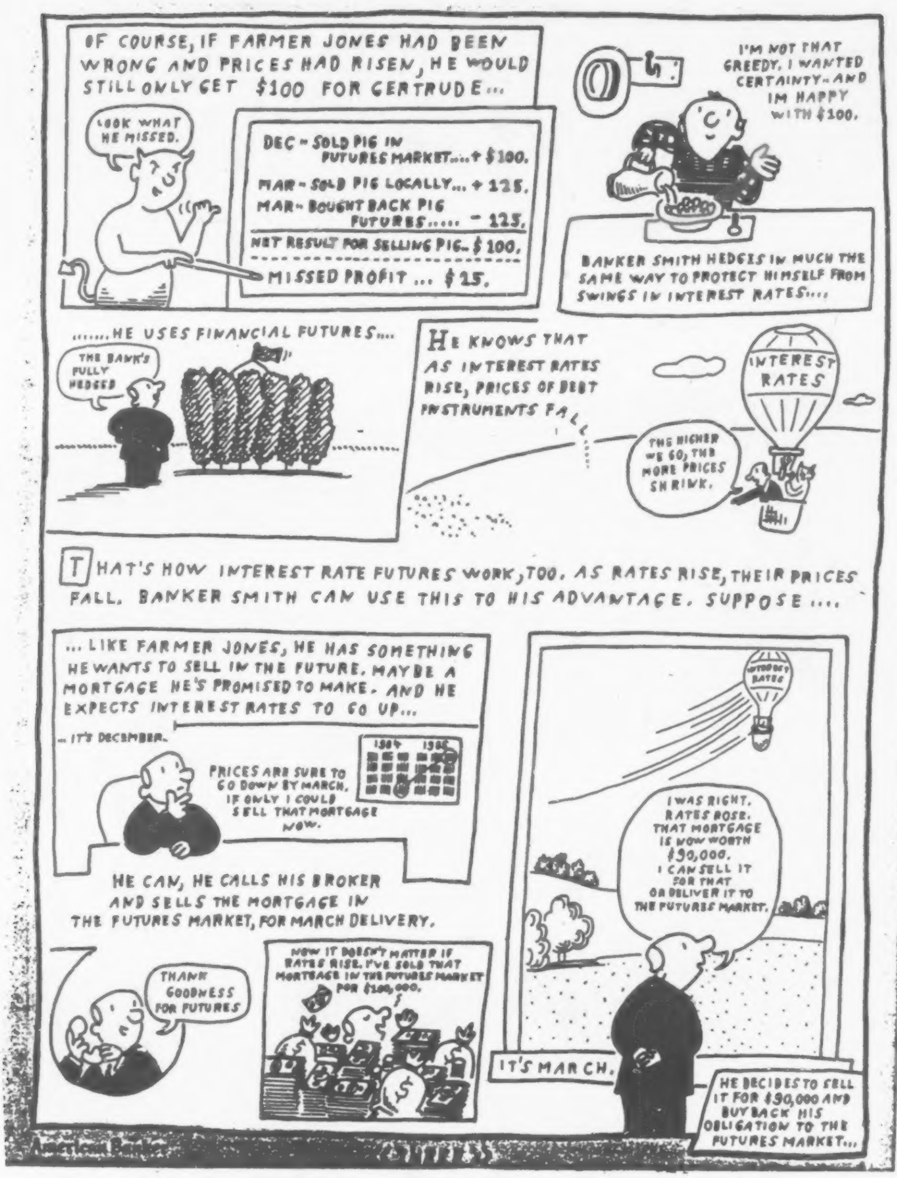
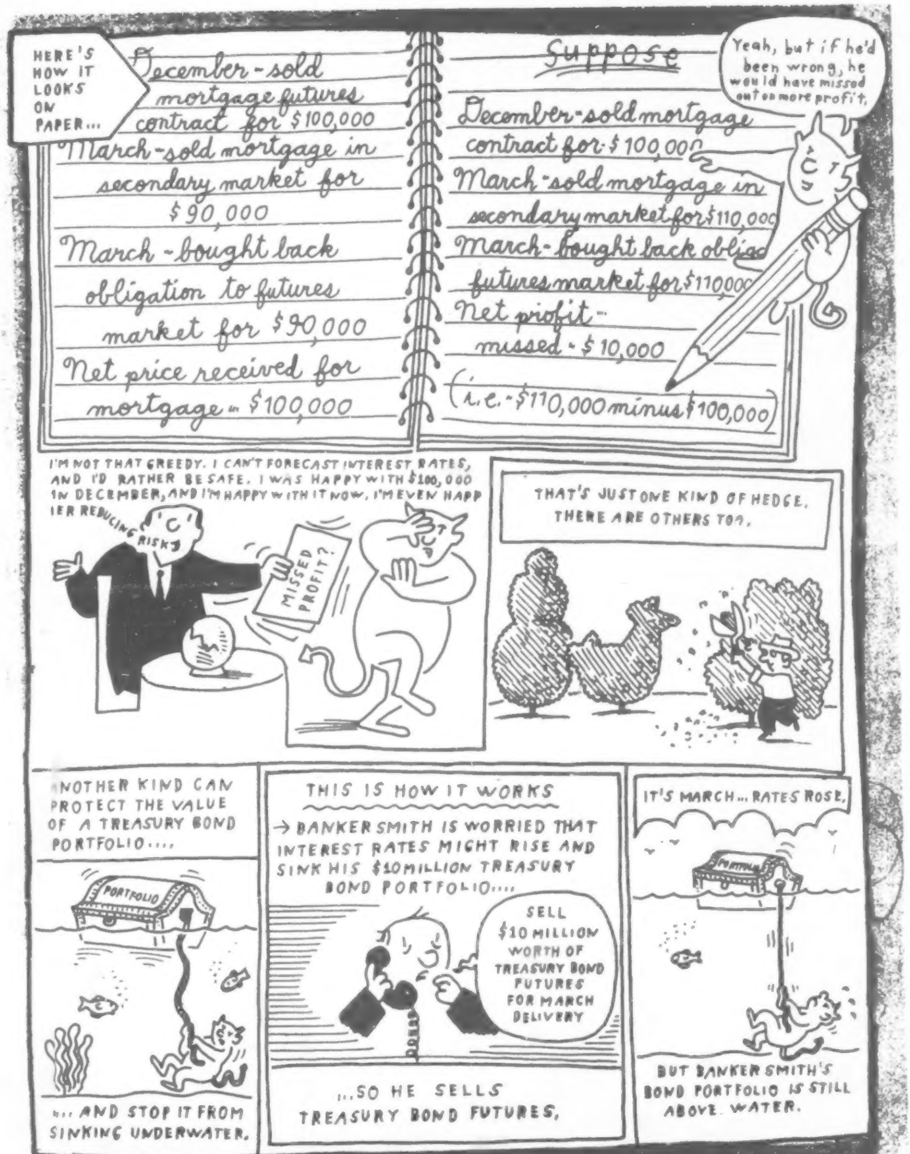
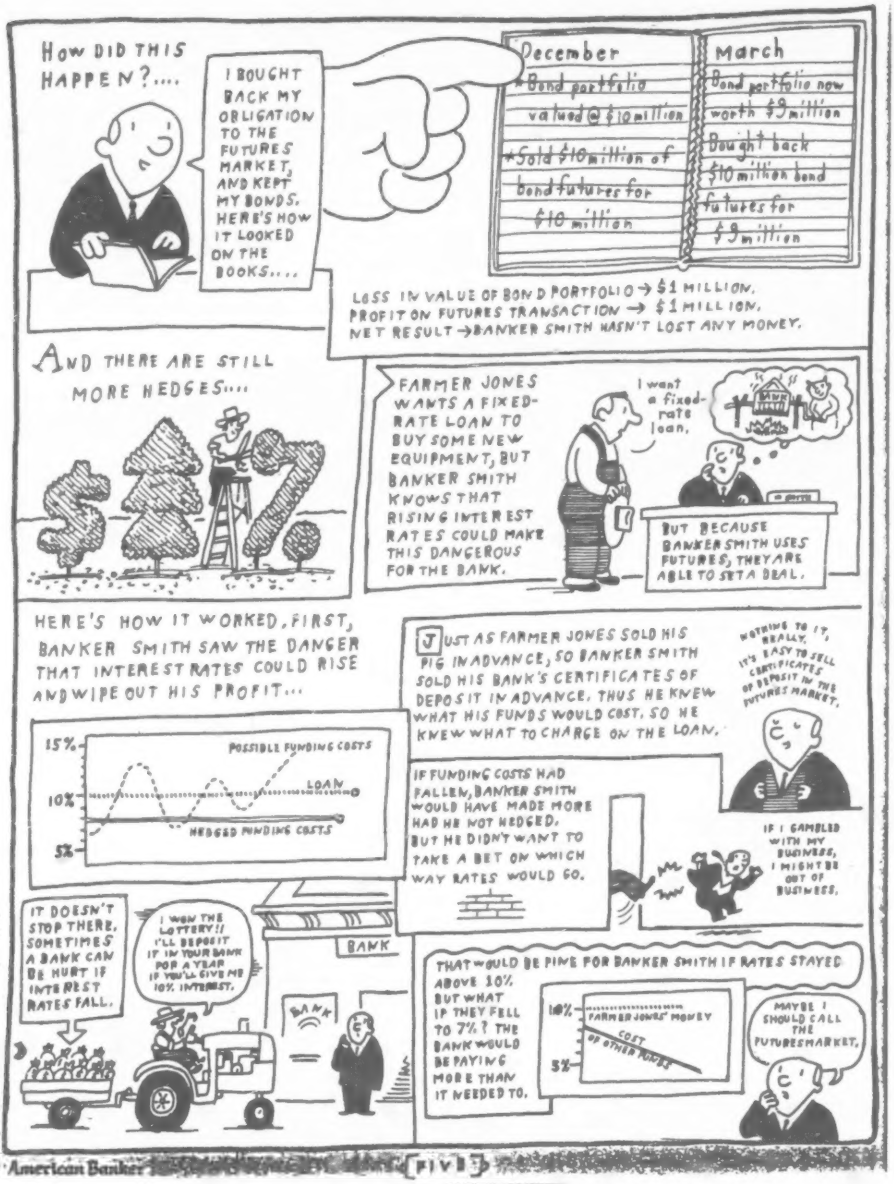
AMBANK
TOMBLOOM
The
FLEDGLING
HEDGING
GUIDE
OR »HOW FINANCIAL FUTURES WORK«
AN AMERICAN BANKER TEACHING GUIDE
AB
THE WORDS BY JOHN MORRIS … THE ART BY TOM BLOOM
FUTURES REPORTER FOR AMERICAN BANKER
CARTOONIST TO THE WORLD-AT-LARGE
54
FARMER JONES AND BANKER SMITH HAVE A LOT IN COMMON. THEY BOTH LIKE TO MAKE MONEY. AND THEY BOTH HAVE FOUND WAYS TO HEDGE THEMSELVES AGAINST THE RISK OF FLUCTUATING PRICES.
BUY MARCH
GO SHORT
SELL SEPTEMBER
I'LL BID $50.
THEY HAVE DISCOVERED THE FUTURES MARKETS
THEY'RE NOT ALL SPECULATORS,
NEITHER ARE WE.
HERE, THEY CAN BUY OR SELL CORN, WHEAT, PIGS OR MONEY IN THE FUTURE, AT A KNOWN PRICE.


FARMING IS EASIER TO UNDERSTAND THAN BANKING.
SO LET'S SEE FIRST HOW FARMER JONES HEDGES....
...IT'S DECEMBER, AND HE PLANS TO SELL HIS PIGS IN MARCH....
OH DEAR, PRICES ARE SURE TO GO DOWN BY THEN. IF ONLY I COULD SELL THEM NOW.
....HE CAN.
...WITH JUST A TELEPHONE CALL HE CAN SELL HIS PIGS IN THE FUTURES MARKET, FOR DELIVERY IN MARCH
GERTRUDE, I'VE SOLD YOU FOR $100.
I'M GLAD I SOLD YOU IN THE FUTURES MARKET WHEN I DID.
IT'S MARCH, FARMER JONES HAS A CHOICE—DELIVER THE PIG INTO THE FUTURES MARKET, OR SELL HER AT THE MARKET IN HIS LOCAL TOWN. HE DECIDES TO SELL LOCALLY.
$70.
$72.
FARMER JONES SELLS GERTRUDE FOR $75.
I MUST CANCEL MY FUTURES OBLIGATION BY BUYING BACK THAT FUTURES CONTRACT. IT WILL PROBABLY COST ME $75.
AND THAT'S WHAT HE DOES.
THIS IS HOW IT WORKED. WITHOUT FUTURES, GERTRUDE WOULD ONLY HAVE FETCHED $75. THE HEDGE MEANT THAT I DIDN'T LOSE MONEY WHEN PRICES FELL.
December—Sold pig in Futures Market for March Delivery + $ 100.
March—Sold Gertrude Locally Instead + 75.
March—Bought Back Pig Futures − 75.
Net Result for Sale of Gertrude $100.

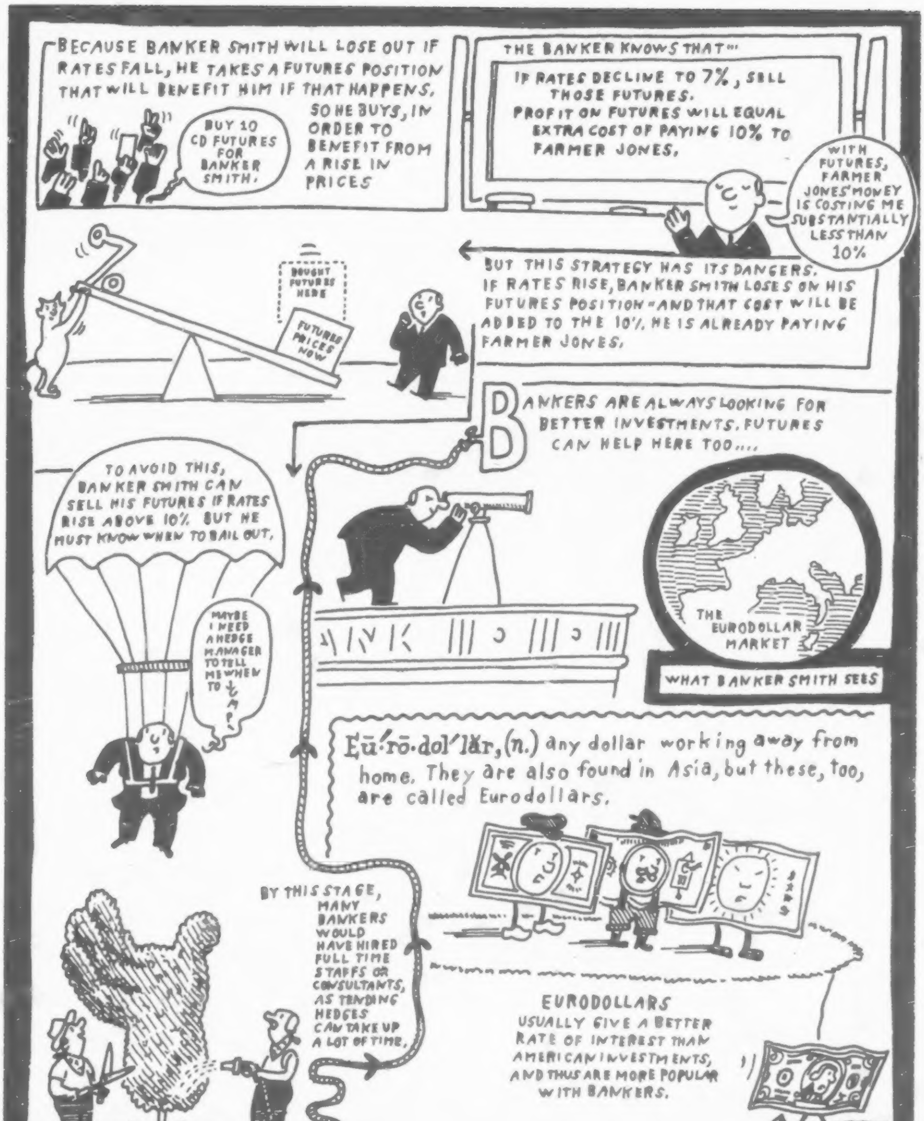

OF COURSE, IF FARMER JONES HAD BEEN WRONG AND PRICES HAD RISEN, HE WOULD STILL ONLY GET $100 FOR GERTRUDE...
LOOK WHAT HE MISSED.
DEC – SOLD PIG IN FUTURES MARKET.... + $100.
MAR – SOLD PIG LOCALLY... + 125.
MAR – BOUGHT BACK PIG FUTURES..... – 125.
NET RESULT FOR SELLING PIG.. $ 100.
MISSED PROFIT ... $ 25.
I'M NOT THAT GREEDY. I WANTED CERTAINTY – AND IM HAPPY WITH $100.
BANKER SMITH HEDGES IN MUCH THE SAME WAY TO PROTECT HIMSELF FROM SWINGS IN INTEREST RATES....
......HE USES FINANCIAL FUTURES....
THE BANK'S FULLY HEDGED
HE KNOWS THAT AS INTEREST RATES RISE, PRICES OF DEBT INSTRUMENTS FALL
INTEREST RATES
THE HIGHER WE GO, THE MORE PRICES SHRINK.
THAT'S HOW INTEREST RATE FUTURES WORK, TOO. AS RATES RISE, THEIR PRICES FALL. BANKER SMITH CAN USE THIS TO HIS ADVANTAGE. SUPPOSE ....
... LIKE FARMER JONES, HE HAS SOMETHING HE WANTS TO SELL IN THE FUTURE. MAYBE A MORTGAGE HE'S PROMISED TO MAKE. AND HE EXPECTS INTEREST RATES TO GO UP...
... IT'S DECEMBER.
1984 1985
PRICES ARE SURE TO GO DOWN BY MARCH. IF ONLY I COULD SELL THAT MORTGAGE NOW.
HE CAN, HE CALLS HIS BROKER AND SELLS THE MORTGAGE IN THE FUTURES MARKET, FOR MARCH DELIVERY.
THANK GOODNESS FOR FUTURES
NOW IT DOESN'T MATTER IF RATES RISE. I'VE SOLD THAT MORTGAGE IN THE FUTURES MARKET FOR $100,000.
INTEREST RATES
I WAS RIGHT. RATES ROSE. THAT MORTGAGE IS NOW WORTH $90,000. I CAN SELL IT FOR THAT OR DELIVER IT TO THE FUTURES MARKET.
IT'S MARCH.
HE DECIDES TO SELL IT FOR $90,000 AND BUY BACK HIS OBLIGATION TO THE FUTURES MARKET...
American Banker

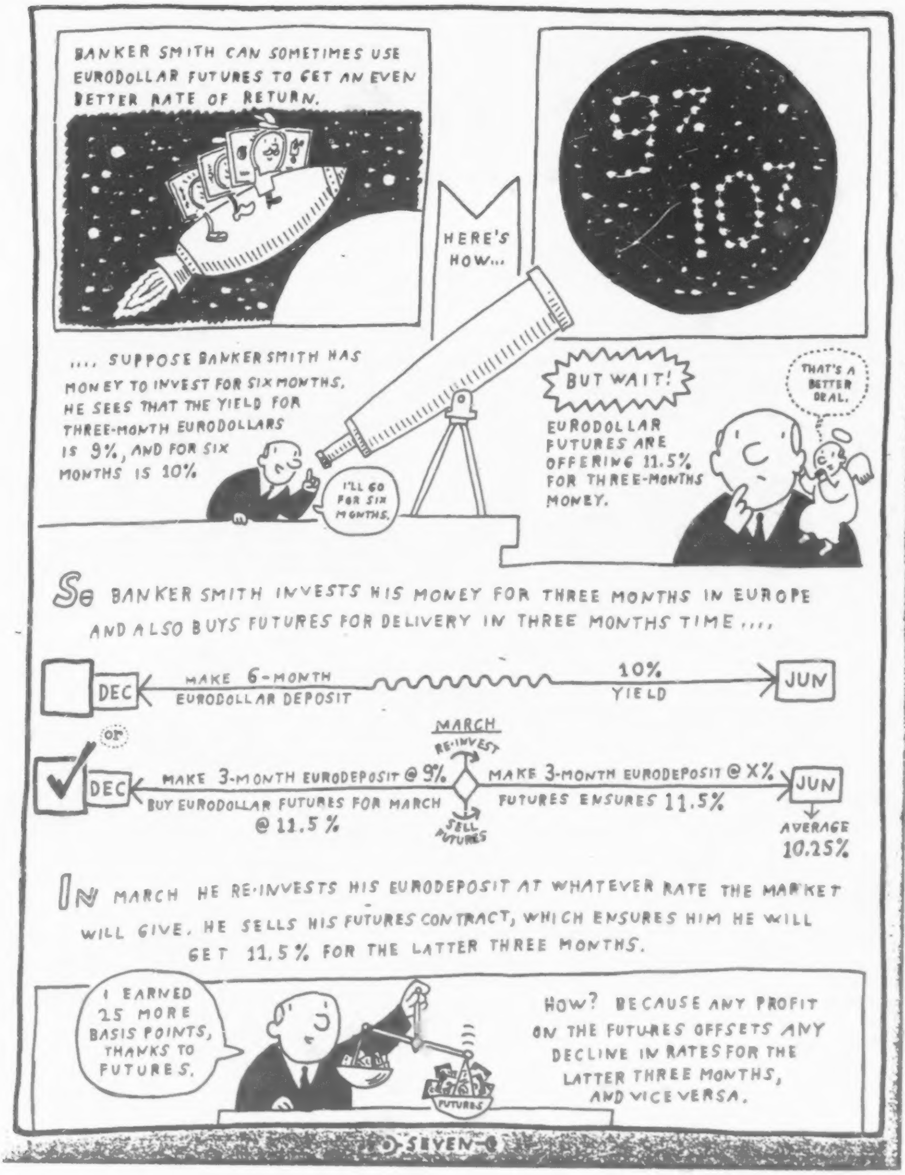

HERE'S HOW IT LOOKS ON PAPER...
December-sold mortgage futures contract for $100,000
March-sold mortgage in secondary market for $90,000
March-bought back obligation to futures market for $90,000
Net price received for mortgage = $100,000
Suppose
December-sold mortgage contract for $100,000
March-sold mortgage in secondary market for $110,00
March-bought back obliga futures market for $110,00
Net profit missed - $10,000
(i.e.-$110,000 minus $100,000)
Yeah, but if he'd been wrong, he would have missed out on more profit.
I'M NOT THAT GREEDY. I CAN'T FORECAST INTEREST RATES, AND I'D RATHER BE SAFE. I WAS HAPPY WITH $100,000 IN DECEMBER, AND I'M HAPPY WITH IT NOW. I'M EVEN HAPPIER REDUCING RISKS
MISSED PROFIT?
THAT'S JUST ONE KIND OF HEDGE. THERE ARE OTHERS TOO.
ANOTHER KIND CAN PROTECT THE VALUE OF A TREASURY BOND PORTFOLIO....
PORTFOLIO
...AND STOP IT FROM SINKING UNDERWATER.
THIS IS HOW IT WORKS
→ BANKER SMITH IS WORRIED THAT INTEREST RATES MIGHT RISE AND SINK HIS $10MILLION TREASURY BOND PORTFOLIO....
SELL $10 MILLION WORTH OF TREASURY BOND FUTURES FOR MARCH DELIVERY
...SO HE SELLS TREASURY BOND FUTURES,
IT'S MARCH... RATES ROSE,
PORTFOLIO
BUT BANKER SMITH'S BOND PORTFOLIO IS STILL ABOVE WATER.

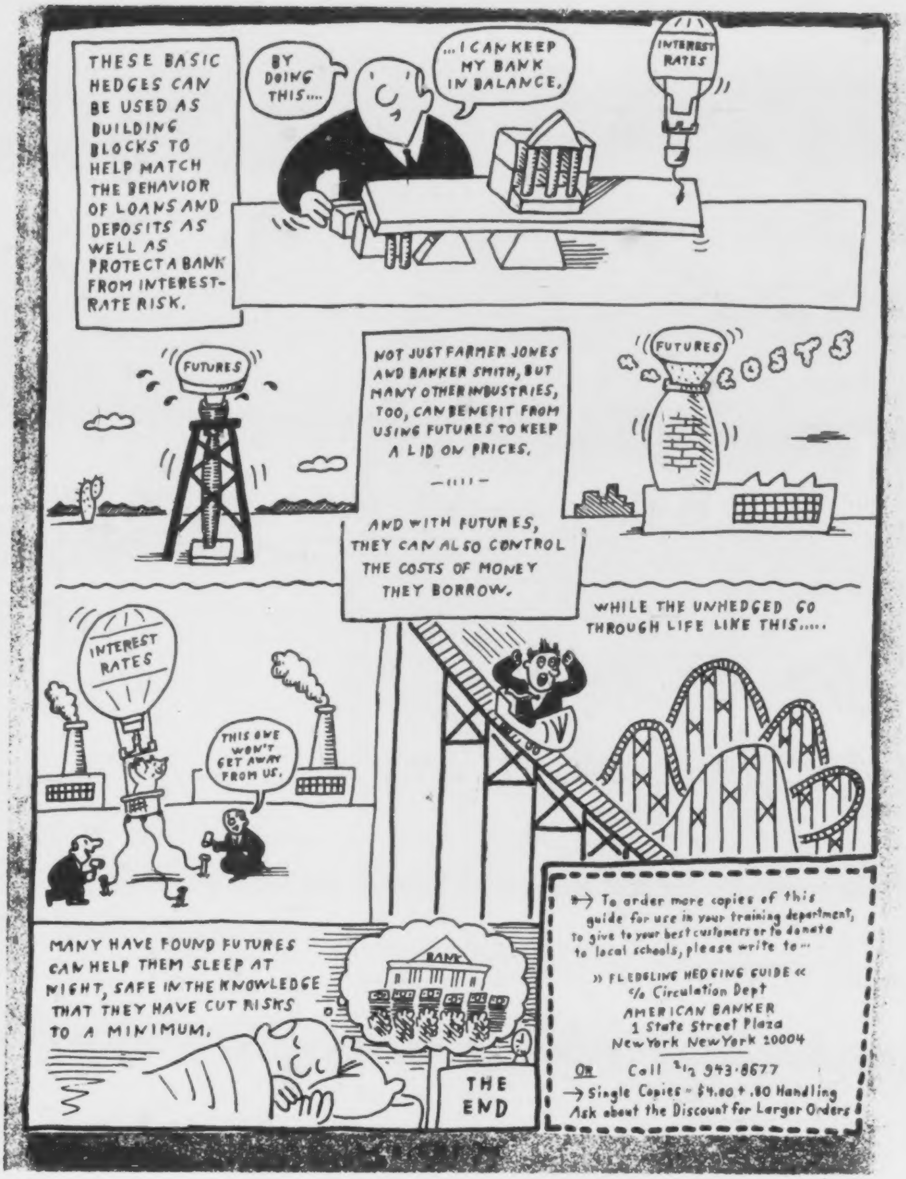

HOW DID THIS HAPPEN?....
I BOUGHT BACK MY OBLIGATION TO THE FUTURES MARKET, AND KEPT MY BONDS. HERE'S HOW IT LOOKED ON THE BOOKS....
December
*Bond portfolio valued @ $10 million
*Sold $10 million of bond futures for $10 million
March
Bond portfolio now worth $9 million
Bought back $10 million bond futures for $9 million
LOSS IN VALUE OF BOND PORTFOLIO → $1 MILLION.
PROFIT ON FUTURES TRANSACTION → $1 MILLION.
NET RESULT → BANKER SMITH HASN'T LOST ANY MONEY.
AND THERE ARE STILL MORE HEDGES....
FARMER JONES WANTS A FIXED-RATE LOAN TO BUY SOME NEW EQUIPMENT, BUT BANKER SMITH KNOWS THAT RISING INTEREST RATES COULD MAKE THIS DANGEROUS FOR THE BANK.
I want a fixed-rate loan.
BANK
BUT BECAUSE BANKER SMITH USES FUTURES, THEY ARE ABLE TO SET A DEAL.
HERE'S HOW IT WORKED. FIRST, BANKER SMITH SAW THE DANGER THAT INTEREST RATES COULD RISE AND WIPE OUT HIS PROFIT...
15%
10%
5%
POSSIBLE FUNDING COSTS
LOAN
HEDGED FUNDING COSTS
JUST AS FARMER JONES SOLD HIS PIG IN ADVANCE, SO BANKER SMITH SOLD HIS BANK'S CERTIFICATES OF DEPOSIT IN ADVANCE. THUS HE KNEW WHAT HIS FUNDS WOULD COST, SO HE KNEW WHAT TO CHARGE ON THE LOAN.
NOTHING TO IT, REALLY. IT'S EASY TO SELL CERTIFICATES OF DEPOSIT IN THE FUTURES MARKET.
IF FUNDING COSTS HAD FALLEN, BANKER SMITH WOULD HAVE MADE MORE HAD HE NOT HEDGED. BUT HE DIDN'T WANT TO TAKE A BET ON WHICH WAY RATES WOULD GO.
IF I GAMBLED WITH MY BUSINESS, I MIGHT BE OUT OF BUSINESS.
IT DOESN'T STOP THERE. SOMETIMES A BANK CAN BE HURT IF INTEREST RATES FALL.
I WON THE LOTTERY!! I'LL DEPOSIT IT IN YOUR BANK FOR A YEAR IF YOU'LL GIVE ME 10% INTEREST.
BANK
BANK
THAT WOULD BE FINE FOR BANKER SMITH IF RATES STAYED ABOVE 10%. BUT WHAT IF THEY FELL TO 7%? THE BANK WOULD BE PAYING MORE THAN IT NEEDED TO.
10%
5%
FARMER JONES' MONEY
COST OF OTHER FUNDS
MAYBE I SHOULD CALL THE FUTURES MARKET.

American Banker

FIVE


BECAUSE BANKER SMITH WILL LOSE OUT IF RATES FALL, HE TAKES A FUTURES POSITION THAT WILL BENEFIT HIM IF THAT HAPPENS.
BUY 10 CD FUTURES FOR BANKER SMITH.
SO HE BUYS, IN ORDER TO BENEFIT FROM A RISE IN PRICES
THE BANKER KNOWS THAT…
IF RATES DECLINE TO 7%, SELL THOSE FUTURES.
PROFIT ON FUTURES WILL EQUAL EXTRA COST OF PAYING 10% TO FARMER JONES.
WITH FUTURES, FARMER JONES' MONEY IS COSTING ME SUBSTANTIALLY LESS THAN 10%
BOUGHT FUTURES HERE
FUTURES PRICES NOW
BUT THIS STRATEGY HAS ITS DANGERS. IF RATES RISE, BANKER SMITH LOSES ON HIS FUTURES POSITION – AND THAT COST WILL BE ADDED TO THE 10% HE IS ALREADY PAYING FARMER JONES.
BANKERS ARE ALWAYS LOOKING FOR BETTER INVESTMENTS. FUTURES CAN HELP HERE TOO....
TO AVOID THIS, BANKER SMITH CAN SELL HIS FUTURES IF RATES RISE ABOVE 10%. BUT HE MUST KNOW WHEN TO BAIL OUT.
MAYBE I NEED A HEDGE MANAGER TO TELL ME WHEN TO JUMP?
ANK
THE EURODOLLAR MARKET
WHAT BANKER SMITH SEES
Eū·rō·dol′lăr, (n.) any dollar working away from home. They are also found in Asia, but these, too, are called Eurodollars.
BY THIS STAGE, MANY BANKERS WOULD HAVE HIRED FULL TIME STAFFS OR CONSULTANTS, AS TENDING HEDGES CAN TAKE UP A LOT OF TIME.
EURODOLLARS USUALLY GIVE A BETTER RATE OF INTEREST THAN AMERICAN INVESTMENTS, AND THUS ARE MORE POPULAR WITH BANKERS.


BANKER SMITH CAN SOMETIMES USE EURODOLLAR FUTURES TO GET AN EVEN BETTER RATE OF RETURN.
HERE'S HOW...
9% 10%
.... SUPPOSE BANKER SMITH HAS MONEY TO INVEST FOR SIX MONTHS. HE SEES THAT THE YIELD FOR THREE-MONTH EURODOLLARS IS 9%, AND FOR SIX MONTHS IS 10%
I'LL GO FOR SIX MONTHS.
BUT WAIT!
EURODOLLAR FUTURES ARE OFFERING 11.5% FOR THREE-MONTHS MONEY.
THAT'S A BETTER DEAL.
SO BANKER SMITH INVESTS HIS MONEY FOR THREE MONTHS IN EUROPE AND ALSO BUYS FUTURES FOR DELIVERY IN THREE MONTHS TIME....
DEC
MAKE 6-MONTH EURODOLLAR DEPOSIT
10% YIELD
JUN
or
DEC
MAKE 3-MONTH EURODEPOSIT @ 9%
BUY EURODOLLAR FUTURES FOR MARCH @ 11.5%
MARCH
RE-INVEST
SELL FUTURES
MAKE 3-MONTH EURODEPOSIT @ X%
FUTURES ENSURES 11.5%
JUN
AVERAGE 10.25%
IN MARCH HE RE-INVESTS HIS EURODEPOSIT AT WHATEVER RATE THE MARKET WILL GIVE. HE SELLS HIS FUTURES CONTRACT, WHICH ENSURES HIM HE WILL GET 11.5% FOR THE LATTER THREE MONTHS.
I EARNED 25 MORE BASIS POINTS, THANKS TO FUTURES.
FUTURES
HOW? BECAUSE ANY PROFIT ON THE FUTURES OFFSETS ANY DECLINE IN RATES FOR THE LATTER THREE MONTHS, AND VICE VERSA.
SEVEN ©


THESE BASIC HEDGES CAN BE USED AS BUILDING BLOCKS TO HELP MATCH THE BEHAVIOR OF LOANS AND DEPOSITS AS WELL AS PROTECT A BANK FROM INTEREST-RATE RISK.
BY DOING THIS....
...I CAN KEEP MY BANK IN BALANCE.
INTEREST RATES
FUTURES
NOT JUST FARMER JONES AND BANKER SMITH, BUT MANY OTHER INDUSTRIES, TOO, CAN BENEFIT FROM USING FUTURES TO KEEP A LID ON PRICES.
AND WITH FUTURES, THEY CAN ALSO CONTROL THE COSTS OF MONEY THEY BORROW.
FUTURES
COSTS
INTEREST RATES
THIS ONE WON'T GET AWAY FROM US.
WHILE THE UNHEDGED GO THROUGH LIFE LIKE THIS.....
MANY HAVE FOUND FUTURES CAN HELP THEM SLEEP AT NIGHT, SAFE IN THE KNOWLEDGE THAT THEY HAVE CUT RISKS TO A MINIMUM.
BANK
THE END
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SPECIAL NCIGF REPORT

STATE INSURANCE GUARANTY FUNDS AND INSURANCE COMPANY INSOLVENCY ASSESSMENT INFORMATION

1969 Through 1984

The NCIGF has recently completed a survey of state guaranty associations regarding assessments made for insolvencies. The information shows the guaranty funds have collected approximately $527,784,672 from insurers between 1969 and 1984. This figure does not include assessments made under the pre-assessment funds in New York and New Jersey (a post-assessment law was adopted in New Jersey in 1974), nor does it include payments made by the individual companies under the insolvency provision of the Uninsured Motorist endorsement. During the same period, guaranty associations have refunded $134,574,891 to member companies. Total net assessments by guaranty associations between 1969 and 1984 equals $393,209,781.

The attached report provides a state-by-state analysis of assessments collected by the guaranty associations. It does not take into consideration recoupments made through premium tax offset and policyholder surcharge provisions. The report also contains a list of insolvencies occurring during the years 1969 and 1984, a listing of total amounts collected and refunded by each state guaranty association, and an exhibit detailing the total amounts assessed for each insolvency.

Richard J. Marcus

Richard J. Marcus
Executive Secretary

RJM:rmc
Enclosures
6/18/85

Alliance of American Insurers
Liberty Mutual Insurance Company
Lumbermens Mutual Casualty Company
Wausau Insurance Companies

American Insurance Association
Crum and Forster
Insurance Company of North America
Travelers Insurance Company

National Association of Independent Insurers
Allstate Insurance Company
Government Employees Insurance Companies
Meridian Mutual Insurance Company

Unaffiliated Companies
CNA Insurance Companies
Continental Insurance Companies
State Farm Insurance Companies

ASSESSMENTS HAVE BEEN MADE BY THE GUARANTY FUNDS TO COVER THE INSOLVENCIES OF THE FOLLOWING COMPANIES:

Company	Declared Insolvent	Domicile
Key Insurance Exchange	1969	California
Fidelity General Insurance Co.	1970	Illinois
Liberty Universal Insurance		Texas
Ohio Valley Insurance Co.		Ohio
Sutton Mutual Insurance Co.		New Hampshire
Citizens Casualty of New York	1971	New York
First American Insurance Co.		Florida
Homeowners Insurance Co.		Illinois
LaSalle National Insurance Co.		Illinois
Los Angeles Insurance Co.		California
Maine Insurance Co.		Maine
Trans Plains Insurance		Texas
United Bonding Co.		Indiana
Maryland National Insurance Co.	1972	Georgia
Metro Casualty Co.		Missouri
Commercial Underwriters	1973	Michigan
First Fire & Casualty Co. of San Antonio, TX		Texas
Gateway Insurance Co.	1974	Pennsylvania
Granite Mutual Insurance Co.		Pennsylvania
Professional Insurance Co.		New York
Rockland Mutual Insurance Co.		Massachusetts
United American Insurers		Iowa
Associated Merchants Mutual Ins. Co.	1975	Massachusetts
Capitol Mutual Fire Insurance Co.		Pennsylvania
Epic Insurance Co.		Arizona
Financial Fire & Casualty Ins. Co.		Florida
Glaco Automobile Insurance Co.		Montana
Guardian Mutual Insurance Co.		Pennsylvania
Interstate Ins. Co. of W. Collingswood		New Jersey
Manufacturers & Wholesalers Indemnity Exchange		Colorado
Medallion/Missouri General Ins. Co.		Missouri
Mobile County Mutual/Mobile Ins. Co.		Texas
National Mutual Insurance Co.		Michigan
Pennsylvania Taximen's Mutual Ins. Co.		Pennsylvania
Resources Insurance Co. of New York		New York
Satellite Insurance Co.		Pennsylvania
Security Fire & Casualty Insurance Co.		South Carolina
State Security Insurance Co.		Pennsylvania
Summit Insurance Co. of New York		New York

Company	Declared Insolvent	Domicile
Transnational Insurance Co.		California
Westgate - California		California
Wisconsin Surety Co.		Wisconsin
Bankers Fire & Casualty Ins. Co.	1976	Florida
Manchester Insurance & Indemnity Co.		Ohio
Southern American Fire Insurance Co.		Florida
Woodland Mutual		Michigan
All-Star Insurance Corporation	1977	Wisconsin
Builders Insurance Co.		Puerto Rico
Empire Mutual Ins. Co./Allcity Ins. Co.		New York
Maryland Indemnity Insurance Co.		Maryland
New York National Insurance Co.		New York
Penn State Mutual Insurance Co.		Pennsylvania
Bankers Mutual Insurance Co.	1978	New York
Commonwealth Insurance Co.		Puerto Rico
Consolidated Mutual Insurance Co.		New York
Consolidated Underwriters		Missouri
Eldorado Insurance Co.		California
Signal/Imperial Insurance Cos.		California
American Reserve Insurance Co.	1979	Rhode Island
Long Island Insurance Co.		New York
Reserve Insurance Co.		Illinois
Atlantic and Gulf States	1980	South Carolina
Concord Mutual Insurance Co.		Pennsylvania
Cosmopolitan Insurance Co.		New York
State Farmers Insurance Co.		Nebraska
Church Laymen Mutual Insurance Co.	1981	West Virginia
Eastern Insurance Co.		Florida
Fauquier Mutual Fire Insurance Co.		Virginia
Market Insurance Co.		Illinois
Proprietors Insurance Co.		Ohio
Security Casualty Co.		Illinois
Amherst Insurance Co.	1982	Pennsylvania
Cotton Belt Insurance Co.		Tennessee
Equitable Insurance Exchange, Inc.		Texas
Great Indemnity Insurance Co.		Puerto Rico
Kenilworth Insurance Co.		Illinois
Lloyds of America		Texas (only)
Main Insurance Co.		Illinois

Company	Insolvent	Domicile
Safeguard Mutual Insurance Co.		Pennsylvania
Stuyvesant Mutual Plate Glass Ins. Co.		Pennsylvania
Interco Underwriters Exchange	1983	California
Lincoln Insurance Company		Puerto Rico
Superior Lloyds		Texas (only)
Western Carriers Insurance Exchange		California
Ambassador Insurance Co.	1984	Vermont
Aspen Indemnity Corp.		Colorado
Colonial Assurance Co.		Pennsylvania
Dome Insurance Company		Virgin Islands
Excalibur Insurance Co.		Minnesota
Financial Security Insurance Co.		Hawaii
Gibraltar Mutual Ins. Co.		Pennsylvania
Golden West Ins. Exchange		California
Guaranty Insurance Company		Puerto Rico
Gulf American		Florida
Horizon Insurance Company		New York
Ideal Mutual Insurance Company		New York
Independent Indemnity Co.		California
Lawyers Prof. Liability Ins. Co.		Florida
Nassau Insurance Co.		New York (only)
North-West Insurance Company		Oregon
Northeastern Fire Ins. Co. of PA		Pennsylvania
Oklahoma Insurance Logistics Co.		Oklahoma
Surety Insurance Company of California		California
Universal Casualty Ins. Co.		Florida

Insolvency Assessments and Refunds

(From November 1969 Through December 31, 1984)

State	Amounts Collected By Guaranty Association	Amounts Refunded By Guaranty Association	Net Assessments
Alabama	$ 2,632,040	$ -0-	$ 2,632,040
Alaska	2,359,182	1,146,866	1,212,316
Arizona	3,553,000	-0-	3,553,000
Arkansas	1,238,356	-0-	1,238,356
California	132,859,622	32,792,232	100,067,390
Colorado	2,622,657	1,207,401	1,415,256
Connecticut	4,393,357	3,731,209	662,148
Delaware	293,800	-0-	293,800
Dist. of Columbia	301,022	41,372	259,650
Florida	124,776,809	6,875,825	117,900,984
Georgia	8,036,704	4,834,264	3,202,440
Hawaii	11,262,357	-0-	11,262,357
Idaho	833,387	46,280	787,107
Illinois	27,699,976	7,766,451	19,933,525
Indiana	1,839,862	595,000	1,244,862
Iowa	5,193,705	450,441	4,743,264
Kansas	1,347,522	72,179	1,275,343
Kentucky	3,264,985	662,440	2,602,545
Louisiana	5,830,857	3,500,000	2,330,857
Maine	1,340,894	70,981	1,269,913
Maryland	3,851,009	1,090,300	2,760,709
Massachusetts	17,233,533	7,151,337	10,082,196
Michigan	17,917,587	6,918,063	10,999,524
Minnesota	13,387,643	6,031,448	7,356,195
Mississippi	1,829,266	191,587	1,637,679
Missouri	2,222,570	849,281	1,373,289
Montana	1,085,350	257,556	827,794
Nebraska	3,394,109	1,735,370	1,658,739
Nevada	5,103,781	1,911,435	3,192,346
New Hampshire	1,200,058	315,545	884,513
New Jersey	13,497,431	12,478,931	1,018,500
New Mexico	900,389	-0-	900,389
New York	*	*	*
North Carolina	1,008,287	709,073	299,214
North Dakota	7,171	-0-	7,171
Ohio	10,859,650	5,878,141	4,981,509
Oklahoma	196,883	-0-	196,883
Oregon	1,598,508	-0-	1,598,508
Pennsylvania	31,475,309	5,791,566	25,683,743
Puerto Rico	32,968,128	16,925,784	16,042,344

State	Amounts Collected By Guaranty Association	Amounts Refunded By Guaranty Association	Net Assessments
Rhode Island	1,623,479	519,769	1,103,710
South Carolina	1,136,891	423,360	713,531
South Dakota	166,908	-0-	166,908
Tennessee	850,396	280,352	570,044
Texas	10,441,800	-0-	10,441,800
Utah	120,182	-0-	120,182
Vermont	1,184,586	-0-	1,184,586
Virginia	629,429	-0-	629,429
Washington	2,838,789	292,352	2,546,437
West Virginia	1,809,329	307,106	1,502,223
Wisconsin	5,438,557	682,468	4,756,089
Wyoming	127,570	41,126	86,444
Total	$527,784,672	$134,574,891	$393,209,781

*New York has a pre-assessment fund.

Total Assessments by Insurer Insolvency

(From November 1969 Through December 31, 1984)

Year	Insolvent Company	Total Collected	Domicile
1969	Key Insurance Exchange	$ 1,350,649	California
1970	Fidelity General Insurance Company	199,580	Illinois
	Liberty Universal Insurance	247,388	Texas
	Ohio Valley Insurance Company	1,362,602	Ohio
	Sutton Mutual Insurance Company	583,363	New Hampshire
1971	Citizens Casualty of New York	2,430,057	New York
	First American Insurance Company	2,569,023	Florida
	Homeowners Insurance Company	601,102	Illinois
	LaSalle National Insurance Company	10,010,862	Illinois
	Los Angeles Insurance Company	1,692,463	California
	Maine Insurance Company	1,880,626	Maine
	Trans Plains Insurance	49,592	Texas
	United Bonding Company	616,151	Indiana
1972	Maryland National Insurance Company	466,921	Georgia
	Metro Casualty Company	500,000	Missouri
1973	Commercial Underwriters	2,998,766	Michigan
	First Fire & Casualty Company of San Antonio, Texas	---	Texas
1974	Gateway Insurance Company	38,679,583	Pennsylvania
	Granite Mutual Insurance Company	1,880,802	Pennsylvania
	Professional Insurance Company	1,609,012	New York
	Rockland Mutual Insurance Company	7,045,713	Massachusetts
	United American Insurers	2,462,946	Iowa
1975	Associated Merchants Mutual Insurance Company	499,911	Massachusetts
	Capitol Mutual Fire Insurance Company	409,735	Pennsylvania
	Epic Insurance Company	---	Arizona
	Financial Fire & Casualty Insurance Company	2,414,820	Florida
	Glaco Automobile Insurance Company	346,576	Montana
	Guardian Mutual Insurance Company	114,685	Pennsylvania
	Interstate Insurance Company of West Collingswood	1,835,085	New Jersey
	Manufacturers & Wholesalers Indemnity Exchange	3,178,836	Colorado
	Medallion/Missouri General Insurance Co.	6,041,485	Missouri
	Mobile County Mutual/ Mobile Insurance Company	8,063,409	Texas

Year	Insolvent Company	Total Collected	Domicile
	National Mutual Insurance Company	200,000	Michigan
	Pennsylvania Taximen's Mutual Ins. Co.	199,620	Pennsylvania
	Resource Insurance Company of New York	4,320,854	New York
	Satellite Insurance Company	257,497	Pennsylvania
	Security Fire & Casualty Ins. Company	19,921	South Carolina
	State Security Insurance Company	548,948	Pennsylvania
	Summit Insurance Company of New York	12,380,159	New York
	Transnational Insurance Company	3,262,647	California
	Westgate-California	2,536,802	California
	Wisconsin Surety Company	851,930	Wisconsin
1976	Bankers Fire & Casualty Insurance Co.	2,036,287	Florida
	Manchester Insurance & Indemnity Co.	13,774,882	Ohio
	Southern American Fire Insurance Co.	297,812	Florida
	Woodland Mutual	646,965	Michigan
1977	All-Star Insurance Corporation	13,543,647	Wisconsin
	Builders Insurance Company	1,883,178	Puerto Rico
	Empire Mutual Insurance Company/ Allcity Insurance Company	4,824,324	New York
	Maryland Indemnity Insurance Company	1,006,088	Maryland
	New York National Insurance Company	---	New York
	Old Security Life Insurance Company	71,549	Missouri
	Penn State Mutual Insurance Company	183,847	Pennsylvania
1978	Bakers Mutual Insurance Company	---	New York
	Commonwealth Insurance Company	23,766,195	Puerto Rico
	Consolidated Mutual Insurance Company	9,747,902	New York
	Consolidated Underwriters	784,607	Missouri
	Eldorado Insurance Company	19,231,619	California
	Signal Insurance Company/Imperial Insurance Company	53,479,447	California
1979	Long Island Insurance Company	582,444	New York
	Reserve Insurance Company/ American Reserve Insurance Company	85,788,315	Illinois/ Rhode Island
1980	Atlantic and Gulf States	374,882	South Carolina
	Concord Mutual Insurance Company	9,987,912	Pennsylvania
	Cosmopolitan Insurance Company	12,218,367	New York
	State Farmers Insurance Company	2,873,674	Nebraska
1981	Church Layman Insurance Company	585,489	West Virginia
	Eastern Insurance Company	817,308	Florida
	Faquier Mutual Insurance Company	321,459	Virginia
	Market Insurance Company	1,250,000	Illinois
	Proprietors Insurance Company	33,472,146	Ohio
	Security Casualty Company	11,613,152	Illinois

Year	Insolvent Company	Total Collected	Domicile
1982	Amherst Insurance Company	99,998	Pennsylvania
	Cotton Belt Insurance Company	324,620	Tennessee
	Equitable Insurance Exchange, Inc.	15,000	Texas
	Great Indemnity Insurance Company	3,162,337	Puerto Rico
	Kenilworth Insurance Company	3,850,790	Illinois
	Lloyds of America (Texas only)	1,084,484	Texas (only)
	Main Insurance Company	1,170,000	Illinois
	Safeguard Mutual Insurance Company	4,999,901	Pennsylvania
	Stuyvesant Mutual Plate Glass Insurance Company	1,999,957	Pennsylvania
1983	Interco Underwriters Exchange	4,216,027	California
	Lincoln Insurance Company	2,706,328	Puerto Rico
	Superior Lloyds	---	Texas (only)
	Western Carriers Insurance Exchange	9,862,520	California
1984	Ambassador Insurance Company	4,481,951	Vermont
	Aspen Indemnity	380,000	Colorado
	Colonial Insurance Company	350,000	Pennsylvania
	Dome	---	Virgin Islands
	Excalibur	6,535,700	Minnesota
	Financial Security Insurance Company	10,062,864	Hawaii
	Gibralter Mutual Insurance Company	---	Pennsylvania
	Golden West Insurance Exchange	---	California
	Guaranty Assurance Company	---	Puerto Rico
	Gulf American	1,569,988	Florida
	Horizon Insurance Company	---	New York
	Ideal Mutual Insurance Company	69,582	New York
	Independent Indemnity Company	---	California
	Lawyers Professional Liability Insurance Company	16,545,490	Florida
	Nassau	---	New York (only)
	North-West Insurance Company	997,207	Oregon
	Northeastern Fire Insurance Company of Pennsylvania	---	Pennsylvania
	Oklahoma Insurance Logistics Company	---	Oklahoma
	Surety Insurance Co. of California	---	California
	Universal Casualty Insurance Company	18,658,472	Florida

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
ALABAMA	START-UP ADMINISTRATIVE ASSESSMENT				26,100			
	Proprietors Ins. Co.	7/82	.00042	Other	199,940	0	Open	156,823
	Security Casualty	-----	-----	-----	0	0	Open	125,000
	Cotton Belt	-----	-----	-----	0	0	Open	
	Gulf American						Open	
	Excalibur	12/84	.005377	Auto	1,830,000	0	Open	1,810,000
			.033875	W.C.	206,000	0	Open	200,000
			.020086	Other	20,000	0	Open	20,000
	Aspen Indemnity	12/84	.005377	Auto	45,500	0	Open	45,500
			.033875	W.C.	16,500	0	Open	16,500
			.020086	Other	118,000	0	Open	118,000
	Main Insurance Co.		.005377	Auto	170,000	0	Open	170,000
ALASKA	LaSalle Ins. Co.	3/72	.0000169951	W.C.	22,987	22,970	Closed	19,888
	Medallion/Missouri	9/75	2%	Auto	361,070	634,376	Closed	1,386,269
	Gen. Ins. Co.	3/76	2%	Auto	810,040			
	Mobile Ins. Co. & Manufacturers & Wholesalers Ind. Exchange	6/76	.0025363	Other	Mobile 24,508 M & W 73,523	12,976	Closed	85,780
	Reserve Ins. Co.	9/79	.0002948	Auto	20,262	476,244	Open	374,000
		9/79	.006076	Other	360,435	0		
	Proprietors Ins. Co.	3/82	,003812836	Other	286,357	0	Open	139,959
ARIZONA (Based on 1982 figures)	Imperial Ins. Co.	6/78	.000419	Auto	90,000	0	Open	2,577,581
		6/78	.002688	Other	234,000			
		12/78	.007312	Other	2,000,000			
	Signal Ins. Co.	6/78	.000419	Auto	0		Closed	5,019
		6/78	.002688	Other	435,000	0		
	Maryland Indemnity Co.	6/78	.000419	Auto	42,000	0	Closed	
		6/78	.002688	Other	2,000			
	Eldorado Ins. Co.	NO ASSESSMENT			0	0	Closed	

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[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
ARIZONA (cont'd.)	Reserve Ins. Co.	10/79	.0021	Auto	550,000	0	Open	264,391
	American Reserve	10/79	.0021	Auto	200,000	0	Open	33,201
	Proprietors Ins. Co.	NO ASSESSMENT					Open	189,976
	Security Casualty	NO ASSESSMENT					Open	218,492
	Kenilworth Ins. Co.	NO ASSESSMENT		Auto			Open	75,000
ARKANSAS	Reserve Ins. Co.	7/79	.000310533237	Other	199,447	0	Closed	142,130
	Cotton Belt	11/82	.000420691		324,620	0	Open	646,000
	Security Casualty						Open	
	Proprietors						Open	
	Excalibur	11/84	.000871037		714,289	0	Open	920,000
CALIFORNIA	Key Ins. Exchange	11/69	.1	Auto	1,350,649	532,336	Closed	816,312
	Citizens Casualty	11/71	.017725	Auto	316,614	1,828,939	Closed	
	Co.	11/71	.05142	Other	1,583,065			61,450
	Los Angeles Ins. Co.	5/73	.08333	Auto	1,692,463	600,000	Closed	1,043,868
	Westgate Ins, Co.	5/75	.058214	Auto	1,268,361			
		5/75	.3051685	Other	1,249,673	3,128,188	Closed	(834,694)
		9/83	.004262488	W.C.	38,768			
	Summit Ins. Co.	9/75	.084	Auto	1,797,285			
		9/75	.1719	Other	1,303,387	2,786,482	Closed	303,497
	Transnational Ins. Co.	12/75	.117	Auto	2,503,296	2,676,110	Closed	(1,300,230)
	Mobile Ins. Co.	3/80	.0202339	Auto	43,291	0	Closed	20,031
	All Star Ins. Co.	6/77	.47092	Other	12,487,534	4,749,367	Open	6,719,549
	Signal Ins. Co.	6/78	.04077	Auto	1,499,802	842,699	Open	10,465,324
		6/78	.39737	Other	13,490,854			
	Imperial Ins. Co.	6/8069/83	.0384408	Auto	1,399,550			
		6/8169/83	.672336496	Other	22,691,142	0	Open	25,151,587
		9/83	.0148898	W.C.	299,997			
	Eldorado Ins. Co.	3/79	.07067	Auto	2,599,603	4,968,116	Open	13,176,245
		3/79	.29635	Other	9,991,847			
		6/8169/83	.49625917	W.C.	6,640,169			

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available.

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
CALIFORNIA (cont'd.)	Medallion Ins. Co.	11/79	.00043	Auto	8,964		Closed	13,645
		11/79	.00012525	W.C.	11,304	0		
		11/79	.0003107	Other	5,066			
	Manufacturer &	11/79	.0093112	Auto	228,632	0	Closed	298,290
	Wholesalers Ins. Co.	11/79	.0088735	Other	171,424			
	United Amer. Und.	11/79	.0011774	Other	39,757	0	Closed	28,324
	American Reserve	6/80	.3415164	Auto	8,999,444	7,000,001	Open	1,609,003
	Ins. Co.	6/80	.0131182	Other	335,868			
	Consolidated Mutual	11/79	.0091827	Other	349,756	79,996	Open	203,062
	Reserve Ins. Co.	6/81	.2352669	Auto	6,200,063	3,599,998	Open	14,139,951
		6/8169/83	.04145633	W.C.	528,822			
		6/81	.6664048	Other	14,102,216			
	Proprietors Ins. Co.	6/82	.0164619	Auto	800,001	0	Open	2,652,346
		6/8269/83	.065261506	Other	2,79[illegible],644			
	Security Casualty			Auto	0	0		
				W.C.	0	0	Open	57,624
	Interco Und. Exch.	9/8369/84	.048053864	Auto	2,801,494			
			.013479063	W.C.	363,907			
			.021526648	Other	1,050,626	0	Open	3,768,484
	Western Carriers Ins. Exchange	9/8369/84	.168738760	Auto	9,837,284	0	Open	5,866,726
	Independent Indemnity				0	0	Open	456,307
	Golden West				0	0	Open	3,651,646
	Excalibur				0	0	Open	2,206,367
COLORADO	Missouri Gen. Ins. Co. & Mobile Ins. Co. & Medallion Ins. Co.	12/75	.0025689	Other	494,680	360,399	Closed	360,399
	Manufacturers &	10/76	.0019575	Auto	459,453	166,551		1,109,823
	Wholesalers Ins.		.0020867	Other	451,505	191,130	Open	
	American Reserve	12/79	.004146	Auto	81,963	110,799	Closed	19,167
	Ins. Co.		.0013532	Other	291,293	374,065		
	Reserve Ins. Co.	12/79	.004146	Auto	85,696		Open	498,971
			.0013532	Other	213,114			
	Consolidated Mutual	12/79	.0013532	Other	4,804	4,457	Closed	1,577
	Proprietors Ins. Co.	6/82	.0009689	Other	450,320	0	Open	373,921
	Security Casualty	6/82	.0001723	Auto	89,829	0	Open	46,503

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
CONNECTICUT	Empire Mutual	1977	.0037	Auto	1,498,577	2,812,851		
		1977	.0019	Other	750,781		Closed	646,086
	Consolidated Ins. Co.	1980, '81	.00009	Auto	49,972	0	Open	605,805
		1980, '81	.0010	Other	549,556	30,024		
	American Reserve Ins. Co.	1980, '81	.0004	Auto	212,499	40,037	Open	298,890
		1980, '81	.00002	Other	12,392	0		
	Reserve Ins. Co.	1980, '81	.0010	Auto	550,229	298,216	Open	679,148
		1980, '81	.0010	Other	549,725	550,081		
	Cosmopolitan Ins. Co.	1981	.0003	Other	159,837	0	Open	242,842
	Ideal Mutual			Auto		0	Open	
				Other		0	Open	
				W.C.		0	Open	
		1982	.00009	Other	59,789			
DELAWARE	Gateway Ins. Co.	10/74	.03	Auto	50,000		Closed	68,000
		3/76			20,000			
	Interstate Ins. Co.	3/76		Auto	20,000		Closed	39,500
	Bankers Fire & Cas.	8/76		Auto	150,000		Closed	89,345
	Reserve Ins. Co.	NO ASSESSMENT					Open	12,000
	American Reserve	NO ASSESSMENT					Open	2,342
	Consolidated Ins. Co.	NO ASSESSMENT					Closed	0
	Proprietors Ins. Co.	NO ASSESSMENT		Auto	53,800		Open	62,764
	Security Casualty Co.	NO ASSESSMENT					Open	5,000
DISTRICT OF COLUMBIA	Rockland Mutual	8/74	.09	Auto	49,990	36,869	Closed	25,922
		2/83	.00068	Auto				
	Interstate Ins.	8/76	.0005	Other	44,817		Closed	52,891
		2/83	.00004	Other	50,238			
	Professional Ins.	8/76	.0005	Other	44,817		Closed	46,181
		2/83	.00005	Other		4,563		
	Wisconsin Surety	8/76	.0001	Other	9,959		Closed	12,643
		2/83	.00001	Other	11,601			
	Consolidated Mutual	6/82	.0004	W.C.	49,914		Open	55,974
		2/83			14,956			
	Reserve Ins. Co.	6/82	.0002	Auto	14,937		Closed	36,369
	Proprietors					0	Closed	1,985
	Security					0	Closed	2,412
	Colonial Assurance					0	Closed	880
	Ideal Mutual					0	Open	
		2/83			4,918			
		6/82	.00006	Other	4,875			

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) when available

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
FLORIDA	Maine Ins. Co.	4/71	1%	Auto	1,142,491	411,200	Closed	60,589
		4/71	1%	Auto,P.D.	663,435	238,617		
	First American Ins. Co.	4/71	1%	Auto	2,016,160	725,648	Closed	851,009
		4/71	1%	Auto,P.D.	552,863	198,847		
	Homeowners Ins. Co.	4/71	1%	Auto,P.D.	110,573	39,769	Open	114,803
		1/73	.0025	W.C.	346,424			
		7/81	1%	W.C.	4,354			
	Citizens Casualty Ins. Co.	4/71	1%	Auto	33,603	12,094	Closed	294
		4/71	1%	Auto,P.D.	78,980	28,407		
		1/72	.001666	Other	117,973	42,515		
		1/73	.0025	W.C.	130			
	LaSalle Ins. Co.	4/71	1%	Auto	134,410	48,377	Closed	(19,979)
		1/72	.001666	Other	471,891	170,058		
		1/73	.0025	W.C.	63,771			
	Maryland Nat'l. Ins. Co.	4/71	1%	Auto	33,603	12,094	Closed	(4,962)
		4/71	1%	Auto,P.D.	173,757	62,495		
	United American Insurers	5/75	1%	Auto	21,527		Closed	146,329
		5/75	1%	Auto,P.D.	14,114	29,034		
		8/75	.0033	Other	196,551			
		6/76	.0007	W.C.	177,773			
		10/79	1%	W.C.	80,000			
		7/81	1%	W.C.	135			
	Gateway Ins. Co.	10/74	1%	Auto	4,362,668		Closed	16,106,086
		10/74	1%	Auto,P.D.	2,615,023			
		5/75	1%	Auto	3,274,130			
		5/75	1%	Auto,P.D.	1,975,952	4,064,752		
		8/75	.0033	Other	262,068			
		6/76	1%	Auto	3,756,269			
		4/77	1%	Auto	3,226,413			
		10/79	1%	Auto	1,531,328			

[1] includes amounts returned as liquidation dividends and excess assessments

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State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
FLORIDA (cont'd.)	Financial Fire & Casualty	5/75	1%	Auto	86,108		Closed	638,095
		5/75	1%	Auto,P.D.	362,258	745,205		
		8/75	.0033	Other	1,725,283			
		6/76	1%	Auto	64,763			
		6/76	.0007	W.C.	25,097			
		4/77	1%	Auto	88,267			
		10/79	1%	Auto	51,044			
		10/79	1%	W.C.	12,000			
	Summit Ins. Co.	6/76	1%	Auto	518,106	0	Closed	1,187,333
		4/77	1%	Auto	436,002			
		10/79	1%	Auto	204,177			
	Resources Ins. Co.	6/76	1%	Auto	1,942,898	0	Closed	4,139,308
		6/76	.007	W.C.	6,275			
		4/77	1%	Auto	1,656,807			
		10/79	1%	Auto	714,624			
		10/79	1%	W.C.	250			
	Mobile Ins. Co.	6/76	1%	Auto	194,289	0	Closed	191,902
		4/77	1%	Auto	173,333			
	Missouri Gen. Ins. Co.	NO ASSESSMENT			0		Closed	0
	Southern Amer. Fire	11/78	1%	Other	287,963	0	Closed	700,097
	Manchester Ins. & Ind.	4/77	1%	Auto	2,005,608	0	Closed	48,507
		10/79	1%	Auto	918,797			
		10/79	1%	W.C.	500			
	Bankers Fire & Cas.	4/77	1%	Auto	1,133,604	0	Closed	1,533,019
		10/79	1%	Auto	510,443			
	Signal Ins. Co.	11/78	1%	Other	1,247,754	0	Closed	560,041
	Imperial Ins. Co.	11/78	1%	Other	8,062,409	0	Open	1,171,478
		10/79	1%	Auto	51,044			
		10/79	1%	W.C.	244,935			
		7/81	1%	W.C.	22,662			

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
FLORIDA (cont'd.)	Consolidated Under. Ins. Co.	10/79	1%	W.C.	110,008	0	Closed	(26,093)
		7/81	1%	W.C.	1,013			
	Commonwealth of Puerto Rico	10/79	1%	Auto	612,531		Open	497,152
		10/79	1%	W.C.	200,000			
	Florida Home Ins. Co.	NO ASSESSMENT			0	0	Closed	16,835
	Reserve Ins. Co.	10/79	1%	Auto	4,491,896	0	Open	9,528,670
		10/79	1%	W.C.	2,755,526			
		7/81	1%	W.C.	645,886			
		7/81	.0025	Auto,P.D.	899,973	31,765		
		5/82	1%	W.C.	1,275,651			
		5/82	.005	Other	1,593[illegible]77			
		9/84	1%	W.C.	491,535			
	Consolidated Mutual	10/79	1%	Auto	816,708	0	Open	7,024,037
		10/79	1%	W.C.	2,977,576			
		5/82	1%	W.C.	811,778			
		5/82	.005	Other	1,013,904			
		9/84	1%	W.C.	436,920			
	Long Island Ins. Co.	10/79	1%	Auto	306,266	0	Closed	325,405
		10/79	1%	W.C.	25,880			
		7/81	1%	W.C.	298			
	American Reserve	7/81	.0025	Auto,P.D.	145,584	5,138	Closed	40,904
	Cosmopolitan Mut.	7/81	1%	Other	4,702,507	0	Open	25,113,970
		5/82	1%	W.C.	1,855,493			
		5/82	.005	Other	2,317,494			
		9/84	1%	W.C.	3,113,053			
	Eastern Ins. Co.	7/81	1%	W.C.	2,054	0	Open	2,144,483
		5/82	1%	W.C.	173,953			
		5/82	.005	Other	217,265			
	Proprietors Ins. Co.	7/81	1%	W.C.	3,478	9,810	Open	1,954,271
		7/81	.0025	Auto,P.D.	277,933			
		5/82	1%	W.C.	1,681,540			
		5/82	.005	Other	2,100,230			
	Kenilworth Ins. Co.	NO ASSESSMENT			0		Open	4,933,578
	Cotton Belt Ins. Co.	NO ASSESSMENT			0		Open	56,704
	Security Cas. Ins. Co.	NO ASSESSMENT			0		Open	1,213,595
	Gulf American Ins. Co.	9/84	1%	W.C.	1,419,988	0	Open	7,487,607
	Lawyers Professional Liability Ins. Co.	9/84	1%	Other	16,545,490	0	Open	23,136,449
	Excalibur Ins. Co.	NO ASSESSMENT				0	Open	3,346,087
	Aspen Insurance Co.	NO ASSESSMENT				0	Open	2,075,578
	Universal Casualty Ins. Co.	12/84	1%	Auto Liab	14,660,962	0	Open	*35,971,724
		12/84	1%	Auto,P.D.	3,907,510			
	Main Insurance Co.	NO ASSESSMENT				0	Open	227,288
	Horizon Ins. Co.	NO ASSESSMENT				0	Open	4,867,508

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
GEORGIA	Maryland Nat'l. Ins.	7/72	.008	Auto	25,000		Closed	25,160
	Summit Ins. Co.	12/76	.0000878	Auto	29,617	17,089	Closed	12,527
	Mobile Home Ins. Co.	12/76	.0037582	Auto	149,660	41,830	Closed	95,189
	Bankers Fire & Cas.	12/76	.0065636	Auto	242,237	165,976	Closed	190,229
	Reserve Ins. Co.	1979/80	.903166515	Auto	6,750,000	4,609,369	Open	3,449,808
	Proprietors Ins. Co.	8/81	.000584633	Auto & Other	416,154		Open	420,798
	Security Casualty	12/81		Auto & Other	0		Open	115,000
	Eastern Ins. Co.	12/81	.000062237	Auto &	424,036		Open	443,894
	Gulf American	1/84		Auto & W.C.			Open	1,405,000
	Excalibur	9/84		Auto & W.C.			Open	2,225,000
	Aspen Indemnity	9/84		Auto & W.C.			Open	435,000
	Main Insurance	10/84		Auto			Open	120,000
HAWAII	Reserve Ins. Co.	8/79		All	1,199,493	0	Open	1,585,843
	Fin. Security Ins. Co.	10/84	2%	Auto	10,062,864		Open	
IDAHO	Homeowners Ins. Co. of Chicago	NO ASSESSMENT						575
	Summit Ins. Co.	7/76	.071				Closed	5,324
	Manufacturers					46,280	Closed	7,678
	Transnational Ins. Co.				133,151		Closed	10,646
	Manchester							0
	Reserve Ins. Co.	7/80	.000947	Other	125,000		Open	103,744
		12/83	.00105	W.C.			Open	50,000
	Proprietors Ins. Co.	8/81					Open	
		10/82	.00395	Other	550,000		Open	614,980
	Security Casualty Co.	12/81						
		12/82					Closed	986
	Western Carriers	12/83	.00033	Auto	25,236		Open	109,550

[1] includes amounts returned as liquilation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
ILLINOIS	LaSalle National Ins. Co.	5/72	.05	Auto	474,788	5,386,689		
		5/72	.05	Other	519,918			
		2/73	.28	Auto	829,157		Closed	3,916,428
	LaSalle National Ins. Co.	2/73	.02	Other	207,805			
		6/73	.1	Other	1,133,584			
		9/73	.2	Other	2,267,282			
		11/73		Auto	664,544			
		9/74		Auto	663,240			
		9/75	.25		345,126			
	Metro Casualty	11/73	.28	Auto	500,000	362,566	Closed	382,695
	Wisconsin Surety Co.	9/75	.25	W.C.	131,800	0	Closed	88,449
	Missouri Gen. Ins. Co.	3/77	.25	Other	429,536	0	Open	359,960
	Consolidated Und.	3/77	.25	Other	74,058	0	Open	107,613
	Summit Ins. Co.	3/77	.25	Other	236,986	0	Closed	109,570
	Manchester Ins. & Ind.	11/77	.0005	Other	1,017,152	1,084,199*	Open	1,044,260
	Long Island Mutual	8/79		Auto	50,000	67,526*	Open	
				Other	200,000	150,000	Open	85,777
	Reserve Ins. Co.	8/79	.067	Auto	800,000	350,000*	Open	685,000
		8/79	.26	Other	8,200,000		Open	14,820,313
	American Reserve	8/79		Auto	250,000	235,000*	Open	40,000
	Consolidated Mutual Ins. Co.	8/79		Auto	100,000	130,471*	Open	
		8/79		Other	400,000			332,065
	Proprietors Ins. Co.	1981,82,83		Auto	35,000		Open	26,737
				Other	1,500,000		Open	1,763,510
	Market Ins. Co.	2/81		Other	500,000			1,595,470
				Other	250,000			
		4/81		Other	500,000		Open	884,876
	Kenilworth Ins. Co.	4/82		Auto	1,500,000		Open	3,095,367
				Other	250,000		Open	264,190
	Security Casualty	1983 & 84		Auto	2,370,000		Open	4,507,703
				Other	300,000		Open	130,310
	Aspen			Auto			Open	12,500
				Other			Open	186,000
	Excalibur			Auto			Open	824,000
				Other			Open	1,883,975
	Main Insurance Co.	12/84		Auto	600,000		Open	560,090
				Other	400,000		Open	207,837

*Includes Interest

[1] includes amounts returned as liquidation dividends and excess assessments

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* Borrowed from Gateway Account - ** Borrowed from the Woodland Mutual Account
***Companion Companies - American Reserve Insurance Company funded by Reserve Insurance Company

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
INDIANA	Gateway Ins. Co.	10/74	.0007765	Auto	343,529	220,000	Closed	91,066
	Summit Ins. Co.	NO ASSESSMENT*					Closed	6,776
	Interstate Ins. Co.	NO ASSESSMENT*					Closed	68,819
	Missouri/Medallion Ins. Co.	NO ASSESSMENT*					Closed	9,622
	Woodland Mutual Ins.	5/77	.0001098988	Other	50,905		Closed	47,333
	Manchester Ins. & Ind.	NO ASSESSMENT*					Closed	100,062
	Imperial Ins. Co.	NO ASSESSMENT**					Closed	5,272
	Proprietors Ins. Co.	12/81	.00028597	Other	235,428		Open	235,000
	Reserve Ins. Co. & American Reserve Ins. Co.***	12/79	.0002813505	Auto	105,000	175,000	Open	500,000
		12/79	.0005716822	Other	245,000	200,000		
		9/81	.0002828003	Auto	109,320			
		9/81	.0004883173	Other	140,680			
	Security Casualty Co.	11/83	.000295742	Auto	235,000		Open	435,000
		11/83	.000246273	Other	200,000			
	Kenilworth Ins. Co.	11/83	.000220234	Auto	175,000		Open	175,000
IOWA	LaSalle National Ins.	12/73	.030		134,902	98,752	Closed	72,739
	United American Ins. Co.	10/74	.103		748,310	301,961	Closed	579,807
		11/75	.046					
	Maryland Ind. Co.	3/78	.027		249,773	49,728	Open	191,209
	Missouri Gen. Ins. Co.	3/78	.002		20,001	0	Closed	21,422
	Proprietors Ins. Co.	9/81	.7623	Other	701,792	0	Open	756,054
	Signal Ins. Co.	9/81	.3258	Other	300,000	0	Closed	166,178
	Reserve Ins. Co.	11/79				0	Open	548,838
		6/80		Other	558,927			
		9/81	.0926					
	Manufacturers & Wholesalers						Closed	6,673
	Security Casualty		.00006		80,000	0	Open	68,714
	Excalibur Ins. Co.	9/84	.001		2,300,000	0	Open	3,473,260
	Aspen Indemnity	9/84	.00008		100,000	0	Open	79,225
KANSAS	United Bonding Co.	6/71	.017696	Other	9,435		Closed	8,599
	Homeowners Ins. Co.	6/71	.017696	Other	40,225		Closed	37,644
	Trans Plains Cas. Co.	12/71	.017519	Other	49,592		Closed	21,785

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State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
KANSAS (cont'd.)	Manufacturers & Wholesalers	6/76	NO ASSESSMENT				Closed	
	Missouri Gen. Ins.	6/76	.010398	Other	49,519		Closed	42,625
	Reserve Ins. Co.	1/80	.023528	Other	199,797	71,973	Open	123,300
	Security Cas. Co.	4/81	NO ASSESSMENT			206	Closed	373
	Proprietors Ins. Co.	1/82	.0513	Other	998,954	0	Open	969,942
	Aspen Indemnity	9/84	NO ASSESSMENT				Open	
	Excalibur Ins. Co.	9/84	NO ASSESSMENT				Open	
	Surety Insurance Co. of California	8/84	NO ASSESSMENT				Open	
KENTUCKY	Summit Ins. Co.	11/75	.0005	Other	282,567	140,952	Open	65,000
	Manchester Ins. & Ind.	10/76	.0016	Other	1,044,892	521,488	Open	566,112
	Mobile Ins. Co.	NO ASSESSMENT					Open	23,373
	Reserve Ins. Co.	9/79	.0004	Other	459,148		Open	578,351
	Proprietors Ins. Co.	10/81	.0003	Other	393,088		Open	432,757
	Kenilworth Ins. Co.	8/82	.0009	Other	1,085,290		Open	1,200,000
	Security Casualty Co.	NO ASSESSMENT						2,000
	Excalibur Ins. Co.		.000483	Other	Undetermined		Open	300,000
	Aspen Indemnity		.000483	Other	Undetermined		Open	300,000
	Main Insurance Co.	NO ASSESSMENT					Open	100,000
LOUISIANA	United Bonding Ins.	5/73	.1	Other	606,716		Closed	62,054
	Homeowners Ins. Co.						Closed	36,336
	Interstate Ins. Co.						Closed	
	Summit Ins. Co.	10/75	.3		2,101,783		Closed	510,427
	Medallion Ins. Co.						Closed	200,767
	Professional Ins. Co.						Closed	142,589
	Imperial Ins. Co.						Open	146,497
	Maryland Indemnity						Open	44,954
	Manchester Ins. & Ind.	8/77	.3		3,122,358	473,334 12/81	Open	2,432,210
	Reserve Ins. Co.						Closed	1,082,050
	Proprietors Ins. Co.						Open	113,601
	Security Cas. Ins. Co.						Open	317
	Gulf American Ins. Co.						Open	
						3,500,000*		

*The Louisiana Insurance Guaranty Association returned $3.5 million in 1983 from assets derived from all sources including company assessments, early access distributions, security deposits and interest income. The refunds were in proportion to the total contributions of each member insurer to the association.

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State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
MAINE	Maine Ins. Co.	5/71	.14%	Auto	74,700	47,979	Closed	75,534
	Professional Ins. Co.	1979	.0001	Other	14,947	3,389	Closed	14,404
	Reserve Ins. Co./Am.R	1979	.0004	Auto	50,018	19,613	Open	217,323
			.0010	Other	147,033		Open	
	Proprietors Ins. Co.		.0001	Auto	19,972	0	Open	42,061
			.00001	Other	2,970	0		
	Security Casualty		.0003	Other	50,067	0	Open	112,991
	Ambassador	9/84	.0033	Auto	607,752	0	Open	
		9/84	.0021	Other	373,435	0	Open	1,365,667
	Excalibur			Auto	0	0	Open	
				W.C.	0	0	Open	51,430
	Ideal Mutual			Auto	0	0	Open	
				Other	0	0	Open	
				W.C.	0	0	Open	
MARYLAND	Gateway Ins. Co.	9/74		Auto	722,894	153,356	Closed	1,508,154
		2/75		Auto	844,978			
	Professional Ins. Co.	9/74		Other	392,206	392,206	Closed	149,014
	Consolidated Mutual	2/83	.00028	W.C.	50,433	0	Open	83,037
	Maryland Ind. Co.	12/77	.001	Other	344,435		Open	3,083,023
		8/79	.000988	Other	321,461			
	Interstate Ins. Co.	8/79		Other	68,010		Closed	68,644
	American Reserve Ins.	NO ASSESSMENT					Closed	7,494
	Reserve Ins. Co.	1981		Auto	356,178	319,779	Open	1,194,611
	Proprietors Ins. Co.	10/81	.001399	Other	750,414	224,759	Open	937,498
MASSACHU-SETTS	Rockland Mutual Ins.	7/74	.2358% of all lines		2,496,596		Open	8,000,137
		11/74	.2830% of all lines		2,999,283			
		6/75	.1353		1,499,844	1,634,738		
	Assoc. Merchants Mut.	6/75	.0451		499,911	289,429	Open	375,478
	Summit of New York	6/75	.2707		2,999,691	849,095	Open	2,923,016
	*Interstate Ins. Co.	10/76	.0001		118,980	58,814	Closed	86,935
	Empire Mutual	12/77	.1340		1,996,440	2,782,403	Closed	1,767,932
	**Consolidated Mutual	11/78	.0002		549,335	100,594	Open	581,130
		12/81	.0001		299,880		Open	
	Amer. Reserve&Reserve	9/79	.0009		1,498,932	1,436,264	Open	3,650,979
		2/83	.000035					
		12/81	.0009		1,899,842		Open	
	Proprietors Ins. Co.	12/81	.0002		419,842		Open	354,854
		2/83	.00003		84,974			
	Cosmopolitan Ins. Co.	8/82	.00003		69,983		Open	89,225
	Ideal Mutual						Open	

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[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

* Members notified on 10/76 - collected 12/77. ** Members notified on 1/79 - collected 9/79

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
MICHIGAN	Nat'l. Mutual Cas.	1/76	.02190151	Auto	200,000	200,000	Closed	144,713
	Summit Ins. Co.	10/76	.01522363	Auto	139,830	23,902	Closed/pending liquidation	107,546
		10/76	.00225591	Other	19,878	13,060		
	Medallion Ins. Co./ Missouri Gen.	12/77	.00472614	Auto	50,000	67,857	Open	652,419
		12/77	.14386411	W.C.	575,000	296,876		
		12/77	.00245772	Other	24,655	35,267		
	Citizens Casualty Co.	11/71	.00727584	Auto	49,712	67,044	Open	262,208
		11/71	.11734205	W.C.	249,980	227,752		
	LaSalle National	12/72	.00836222	Auto	64,000	95,000	Open	709,755
		12/72	.31492751	W.C.	720,000	1,038,578		
	Commercial Under.	8/75	.26257485	Auto	2,398,766	736,822	Open	3,626,888
		8/75	.17684029	W.C.	600,000	488,241		
	Woodland Mut. Ins. Co.	7/77	.01907331	Auto	175,000	10,017	Open	
		7/77	.04774261	W.C.	421,060	89,983		1,015,865
	Res.rve Ins. Co.	4/80	.02113965	Auto	326,752	328,000		
		4/80	.00164206	W.C.	12,399	13,000	Open	
		4/80	.11309445	Other	1,648,307	1,405,664		
		4/81	.00063597	Other	999,994			2,418,520
	Consolidated Mutual	4/80	.00048799	W.C.	374,249	423,000	Open	
		4/80	.00025600	Other	372,996	258,000		318,384
	American Reserve	4/80	.01059294	Auto	163,615			
		4/80	.02291793	Other	333,886		Open	
		4/81	.01591147	Other	249,906			749,890
	Proprietors Ins. Co.	2/82	.48286132	Other	7,497,608	1,100,000	Open	6,769,159
	Security Casualty	8/84	.01037128	Auto	180,994	0		
		8/84	.01499657	W.C.	69,001	0	Open	460,167

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
MINNESOTA	LaSalle Nat'l. Ins. Co.	9/73	.02740	Auto	90,000		Closed	137,354
			.07586	Other	235,000	0		
		5/76				199,776		
	United Amer. Insurers	12/74	.206471% of auto premiums		285,000	649,901	Closed	
			.062139% of other		215,000			
		10/75		Auto	550,000			
				Other	50,000			
	Summit Ins. Co.	3/76		Auto	75,000	0	Open	
	Mobile Ins. Co.	3/76		Auto	10,000		Open	
				Other	265,000	0		
	Manufacturers & Wholesalers	3/76		Auto	220,000	179,937		
				Other	5,000			
	Manchester Ins. & Ind.	10/76			986,358	5,001,834	Open	6,000,000
		2/78			2,434,494			
	Reserve Ins. Co.	5/80		Other	999,812		Open	
	Proprietors Ins. Co.	2/82		Auto	26,000			
				Fid.&Sur.	17,000		Open	
				Other	2,904,000			
	Security Casualty Ins.	10/83	.0051	Auto	3,873,069	0	Open	5,750,000
		1984		Auto	126,910			
MISSISSIPPI	Liberty Universal	7/74	.1192	None	247,388	111,807	Closed	135,581
	Homeowners Ins. Co.	3/75	.0445	None	99,526	79,780	Closed	10,883
	Medallion Ins. Co./ Missouri Gen. Ins.	3/76	.1701	None	597,205	0	Open	397,790
	Manchester Ins.&Ind.	6/76	.0683	None	251,018	0	Open	144,922
	Mobile Ins. Co.	3/77	.000543	None	200,063	0	Closed	640,375
		4/81	.001180		434,066	0	Open	49,893*
	Reserve Ins. Co.	NO ASSESSMENT						
	Proprietors Ins. Co.	NO ASSESSMENT						
	Security Casualty Ins.	NO ASSESSMENT						
	Cotton Belt Ins. Co.	NO ASSESSMENT						

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* Claims paid to 12/79, no information provided regarding potential claims

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
MISSOURI	LaSalle Ins. Co. & Metro Casualty Co.	8/73	.012	Other	48,082	0	Closed	72,524
	Medallion Ins. Co. & Missouri Gen. Ins.	10/75	.1171	Auto	488,953	140,000	Open	400,477
	United Amer. Insurers	10/75	.0203	Auto	84,779	0	Closed	74,800
	Manchester Ins.&Ind.	12/76	.1721	Auto	763,856	709,281	Open	478,785
	Manufacturers & Wholesalers Ind.	NO ASSESSMENT					Closed	23,059
	Summit Ins. Co.-NY	NO ASSESSMENT				0	Closed	21,293
	Mobile Ins. Co.	NO ASSESSMENT				0	Closed	270
	Interstate Ins. Co.	NO ASSESSMENT				0	Closed	6,896
	Reserve Ins. Co. & American Reserve	12/79	.07	Other	431,900	0	Open	366,839
	Proprietors Ins. Co.				90,000		Open	90,000
	Security Casualty				45,000		Open	60,000
	Kenilworth Ins. Co.				270,000		Open	175,000
MONTANA	Glaco Ins. Co.	8/75		Auto	346,576	237,556	Closed	381,648
	Manufacturers & Wholesalers	4/77	.00439223	Auto	400,381	0	Open	272,475
	Mobile Ins. Co.	4/77	.002509843	Other	69,940	0	Closed	47,700
	Manchester Ins.&Ind.	NO ASSESSMENT				0	Closed	1,378
	Medallion/Missouri				116,344	0	Closed	111,440
	Reserve Ins. Co.				80,476	0	Open	79,193
	All Star Ins. Co.	1/81			73,233	0	Open	69,673
	Proprietors Ins. Co.	NO ASSESSMENT					Open	23,000
	Security Casualty Ins.	NO ASSESSMENT					Open	25,000
NEBRASKA	Missouri Gen. Ins.	12/76	.0018161	Other	3,000	0	Closed	1,117

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State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
NEBRASKA (cont'd.)	Manufacturers &	12/76	.0895469	Auto	123,955			21,598
	Wholesalers	12/76	.1338235	Other	220,987	299,125	Closed	166,545
	Reserve Ins. Co.	9/80	.0034810	Other	9,461	0	Closed	12,039
	State Farmers Ins.	10/80	.9999980	Other	2,873,674	1,436,245	Open	5,645,183
	Proprietors Ins. Co.	11/82	.0032440	Other	9,789	0	Closed	10,114
	Security Casualty	8/84	.0093380	Auto	21,698	0	Open	21,698
			.0329790	Other	16,932	0	Open	16,932
			.0054920	W.C.	23,350	0		42,350
	Excalibur	12/84	.2713350	Auto	68,817	0	Open	773,000
			.0663110	Other	13,016	0		208,200
			.0226190	W.C.	9,430	0		18,800
NEVADA	Transnational	12/75	.2209		251,998	214,487	Closed	(5,000)
	Mobile Ins. Co.	12/75	.04909		55,997			
		11/79	.00735		9,640			
		9/76	.0077		8,834			
		9/82	.00755		8,473	49,612	Closed	26,000
	Medallion Ins. Co.	12/75	.02862		33,791	35,023	Closed	(1,232)
	Manufacturers &	9/76	.00126		107,600		Closed	
	Wholesalers	10/77	.00164		2,200			
		11/83	.0079		10,499	70,687	Closed	47,000
	Manchester Ins.&Ind.	9/76	.12558		166,290	179,404	Closed	(13,116)
	Maryland Indemnity	8/78	.026		46,069			
		9/82	.0013		2,350	20,702	Closed	20,000
	Signal Ins. Co.	8/78	.0769		160,982	200,542	Closed	(65,000)
	Imperial Ins. Co.	8/78	.4774		999,933	439,079	Closed	500,000
	Reserve Ins. Co.	11/79	.280969		698,390	511,862	Closed	100,000
	American Reserve Ins.	11/79	.040138		99,769	133,008	Closed	(45,000)
	Security Casualty	9/82	.016765		64,992	37,029	Closed	(5,000)
	Ambassador	11/84	.0059		2,377,976		Open	2,500,000
NEW HAMPSHIRE	Sutton Mutual Ins.	6/71	.005	Auto	232,036		Closed	1,043,643
		2/73	.0075	Auto	351,329	276,505		
	American Reserve/						Closed	
	Reserve Ins. Co.					33,051	Open	58,659
	Consolidated Mutual	2/84		Other	33,351		Open	38,969

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State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
NEW HAMPSHIRE (cont'd.)	Proprietors Ins. Co.	1982	.0002	Auto	28,262		Closed	62,518
			.0003	Other	56,153	1,901	Closed	
	Security Casualty					6,088	Closed	6,321
	Ambassador	9/84	.0007	Other	126,801	-	Open	475,601
	Excalibur	9/84	.0002	Auto	48,656		Open	
			.0005	Other	84,540		Open	740,581
			.0025	W.C.	240,952		Open	
	Ideal Mutual			Auto	0		Open	
				Other	0		Open	
				W.C.	0		Open	
NEW JERSEY	Gateway Ins. Co.				8,986,092	8,986,092		
	Professional Ins. Co.				998,603	998,603		✓
	*				3,512,736	2,494,236		
	Summit Ins. Co.	NO ASSESSMENT						✓
	Resources Ins. Co.	NO ASSESSMENT						✓
	Interstate Ins. Co.	NO ASSESSMENT						
	Allcity Ins. Co.	NO ASSESSMENT						✓
	Empire Mut. Ins. Co.	NO ASSESSMENT						
	Maryland Ind. Ins. Co.	NO ASSESSMENT						
	Signal Ins. Co.	NO ASSESSMENT						
	Imperial Ins. Co.	NO ASSESSMENT						
	Bakers Mutual Ins. Co.	NO ASSESSMENT						
	Consolidated Mutual	NO ASSESSMENT						
	Reserve Ins. Co.	NO ASSESSMENT						
	Long Island Mutual	NO ASSESSMENT						
	Cosmopolitan Mutual	NO ASSESSMENT						
	Proprietors Ins. Co.	NO ASSESSMENT						
	Security Casualty Co.	NO ASSESSMENT						
	Ambassador Ins. Co.							
	Ideal Mutual Ins. Co.							
	* Assessment Not Allocated To A Particular Insolvency							
NEW MEXICO (Based on 1981 figures)	Mobile Ins. Co.	11/75*	.003*	Auto*	256,942*	*	Open*	5**
		12/79*	.00438*	Other*	643,447*	*		
	Summit Ins. Co.	11/75*	.003*	Auto*		*	Open*	49,855**
		12/79*	.00438*	Other*		*		
	Manufacturers & Wholesalers	11/75*	.003*	Auto*		*	Open*	0**
		12/79*	.00438*	Other*		*		
	All Star Ins. Co.	11/75*	.003*	Auto*		*	Open*	270,043**
		12/79*	.00438*	Other*		*		

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* Assessments and interest allocated by account only and not by insolvency. ** Direct and indirect costs allocated by insolvency

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
NEW MEXICO (cont'd.)	American Reserve	11/75*	.003*	Auto*		*	Open*	168,775**
		12/79*	.00438*	Other*		*		
	Reserve Ins. Co.	11/75*	.003*	Auto*		*	Open*	86,696*
		12/79*	.00438*	Other*		*		
NORTH CAROLINA	Summit Ins. Co.	11/75	.000141002	Auto	65,237	37,710	Closed	35,783
		11/75	.000032457	Other	9,527			
	Empire Mut. Ins. Co.	5/78	.000759648	Auto	432,877	510,443		0
		5/78	.000036741	Other	15,967	18,788	Closed	
	Reserve Ins. Co.	11/79	.000244665	Auto	157,319	0	Open	60,000
		11/79	.000408196	Other	205,613			
	American Reserve	11/79	.000189382	Auto	121,767	142,132	Closed	0
	Proprietors Ins. Co.	NO ASSESSMENT					Open	0
	Security Casualty	NO ASSESSMENT					Open	0
	Excalibur Ins. Co.	NO ASSESSMENT					Open	500,000
	Ideal Mutual	NO ASSESSMENT					Open	
NORTH DAKOTA	Manchester Ins.&Ind.	7/77	.000034961	Auto	4,792	0	Closed	2,728
			.000034961	Other	2,225		Closed	403
	Reserve Ins. Co.	6/80	.00007233	Auto			Closed	0
			.00007233	Other	154	0		8,826
	Security Ins. Co.			Auto			Closed	0
		1982		Other		0	Closed	4,205
	Proprietors Ins.	1983		Auto			Closed	
				Other		0	Closed	171
	Aspen Indemnity	1984		Auto		0	Open	14,030
				Other		0	Open	2,800
	Excalibur Insurance	1984		Auto		0	Open	16,180
	Ideal Mutual					0	Open	
OHIO	Ohio Valley Ins. Co.	1970		Auto	1,362,602	790,244	Closed	788,246
	Manchester Ins.&Ind.	8/76	.00104	Auto	1,004,493	1,452,065	Open	1,258,381
		8/76	.00004	Other	32,049	32,049		
	Transnational Ins.	NO ASSESSMENT				0	Closed	7,336
	Interstate Ins. Co.	NO ASSESSMENT				0	Closed	13,287
	Maine Ins. Co.	NO ASSESSMENT				0	Closed	76,822
	Summit Ins. Co.	NO ASSESSMENT				0	Closed	13,546
	LaSalle National	NO ASSESSMENT				0	Open	320,080

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State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
OHIO (cont'd)	Reserve Ins. Co &	7/79		Auto	2,757,437	1,645,145	Open	3,106,157
	American Reserve	7/79		Other	345,842			
	Proprietors Ins. Co.	11/81	.00234627	Other	3,507,227	1,958,658	Open	3,471,148
	Security Casualty	12/81	.000450	Auto	700,000		Open	700,000
	Colonial	3/84		Other	350,000		Open	350,000
	Excalibur	9/84		Auto	700,000			700,000
	Aspen	9/84		Other	100,000		Open	100,000
OKLAHOMA	Proprietors Ins. Co.	11/81		Other	196,883		Open	279,285
	Security Casualty	NO ASSESSMENT					Open	
OREGON	Summit Ins. Co.	8/75			299,277		Closed	188,194
	Transnational Ins.	12/75			125,000		Closed	107,955
	Medallion Ins. Co.	12/75			323,011		Closed	340,677
	Signal Ins. Co.						Closed	4,643
	Manufacturers & Wholesalers						Closed	92,221
	Eldorado						Open	2,555,000
	American Reserve						Open	115,000
	Reserve Ins. Co.	1/82			351,190		Open	1,186,000
	Proprietors Ins.	1/82			500,030		Open	500,000
	Security Casualty						Open	35,000
PENNSYLVANIA	Granite Mut. Ins. Co.	9/74	.0020534	Auto	1,880,802	859,816	Closed	1,044,179
	Gateway Ins. Co.	9/74	.0010779	Auto	977,710		Open	
		3/75	.0011076	Auto	1,045,916			
		3/75	.0005382	Other	800,000			
		2/76	.0006863	Auto	644,043	120,173		4,361,025
		3/79	.0005205	Auto	841,115			
	Summit Ins. Co. of NY	2/76	.0007993	Auto	748,568	339,281	Closed	385,159
	Pennsylvania Taximen's Ins. Co.	2/76	.0002131	Auto	199,620	70,562	Closed	129,938

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State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
PENNSYLVANIA (cont'd)	State Security Ins.	2/76	.0005861	Auto	548,948	486,543	Closed	352,228
	Guardian Mut. Ins. Co.	2/76	.0000277	Auto	25,901	92,200	Closed	70,571
		2/76	.0000567	Other	88,784			
	Interstate Ins. Co.	2/76	.0000767	Auto	71,850		Open	1,306,828
		2/76	.0001346	Other	206,847			
		4/77	.0002883	Other	491,900	34,782		
		3/79	.0002092	Other	496,875			
	Satellite Ins. Co.	2/76	.0002749	Auto	257,497	132,087	Closed	200,823
	Capitol Mut. Fire Ins. Co.	2/76	.0003197	Auto	299,416	89,580	Closed	364,518
		3/79	.0000682	Auto	110,319			
	Penn State Mut. Ins.	3/79	.0000774	Other	183,847	67,251	Closed	166,121
	Old Security Life	3/79	.0000301	Other	71,549	0	Closed	66,333
	Consolidated Mutual Ins. Co.	3/80	.0000136	Auto	24,893			823,130
		3/80	.0001837	Other	475,673	0	Open	
	American Reserve	12/82		Auto		0	Closed	15,189
				Other				
	Reserve Ins. Co.	3/80	.00041	Auto	248,872	0	Open	2,687,319
		3/80	.0015544	Other	749,209			
		3/81	.00041	Auto	247,758			
		3/81	.0015544	Other	748,599			
	Concord Mut. Ins. Co.	3/81	.0025254	Auto	2,000,133	3,499,291	Open	8,712,672
		11/81	.0025254	Auto	3,000,261			
		12/81	.0023366	Auto	4,987,518			
	Cosmopolitan Mutual	12/82		Other			Closed	1,418
	Proprietors Ins. Co.	12/81	.0001229	Auto	262,502	0	Open	1,382,279
		12/81	.0004505	Other	738,637			
	Safeguard Mutual	10/83	.0022106	Auto	4,999,901	0	Open	8,135,760
				Other				
	Stuyvesant Mutual	12/83	.0008732	Auto	1,974,961	0	Open	1,891,849
			.0000151	Other	24,996			
	Amherst	12/83	.0000442	Auto	99,998	0	Open	1,593,627
			.0005446	Other	899,891			
	Colonial Assurance	12/84				0	Open	1,682,176
	Northeastern Fire	12/84				0	Open	2,458,446
	Gibraltar	12/84				0	Open	237,654

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PUERTO RICO	Builders Ins. Co.	5/77	2.0%	Surety	139,677			
		6/77	0.5%	Auto	491,620			
			0.25	Cas.	61,173	1,883,178	Closed	0
			0.5%	Other	354,368			
		2/78	2.0	Surety	192,956			
		6/79	2.0	Surety	188,259			
		1/80	2.0	Surety	210,095			
		1/81	2.0	Surety	245,230			
	Commonwealth Ins. Co.	8/78	2.0	Auto	2,008,116			
			2.0	Cas.	498,009			
			2.0	Other	940,156			
		7/79	2.0	Auto	2,530,905			
			2.0	Cas.	883,603			
			2.0	Other	1,459,309			
		1/80	1.75	Auto	2,335,282			
			1.50	Cas.	770,143			
			2.0	Other	1,362,646			
		1/81	1.5	Auto	2,019,464		Open	18,000,000
			1.5	Cas.	803,225			
			1.9	Other	1,852,735			
		1/82	1.5	Auto	2,221,788			
			1.5	Cas.	743,041			
			1.5	Other	1,346,160			
		1/83	.5	Cas.	238,606	12,597,384		
		2/84	1.50	Cas.	799,038			
		10/84	.25	Cas.	141,438			

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State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
PUERTO RICO (cont'd.)	Reserve Ins. Co.	1/80	.25	Auto	339,633	1,222,611		
			.50	Cas.	154,996			
		1/81	.5	Auto	675,859			
			.5	Cas.	178,910		Open	2,000,000
			.1	Other	87,053			
		1/82	.25	Auto	370,442			
			.25	Cas.	120,702			
			.1	Other	89,257			
		1/83	.5	Cas.	245,767			
	Consolidated Mut.						Open	100,000
	Great Indemnity Ins. Co.	8/82	.25	Auto	370,339			
			.25	Cas.	121,691		Open	4,000,000
			.25	Other	362,757			
		8/83	1.0	Auto	1,281,496			
			1.0	Cas.	496,671			
		2/84	.25	Auto	396,215			
		2/84	.25	Cas.	133,168			
	Lincoln Ins. Co.	2/84	1.0	Auto	1,584,860			3,900,000
			.75	Auto	1,121,468			
	Guaranty Insurance Co.						Open	2,500,000
RHODE ISLAND	Interstate Ins. Co.	1976-77	.0010	Auto	79,822	19,003	Open	98,012
		1976-77	.0003	Other	19,342			
	Empire Mut. Ins. Co.	1979	.0009	Auto	99,796		Closed	74,095
			.0009	W.C.	29,906	170,167		
	Consolidated Mutual	10/79	.0007	Auto	9,914	J		
		10/79	.0003	W.C.	9,353	41,157	Open	113,949
		10/79-80	.0003	Other	110,046			
	American Reserve & Reserve	1979	.0011A-.0008	Auto	249,943	289,442	Open	481,116
		1980	.0002A-.0012	Other	294,911			
		1981	.003A-None					
	Proprietors Ins. Co.	1981	.0002A-.00003	Auto	80,814			
		1982	.0003A-.0002	Other	39,743	0	Open	134,323
	Security Casualty	1981	.0039A	Auto	599,889	0	Open	1,109,578
	Ideal Mutual			Auto			Open	
				Other			Open	
				W.C.			Open	

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
SOUTH CAROLINA	Gateway Ins. Co.	9/74	.0017760	Auto	399,455	160,647	Closed	147,104
	Fidelity Ins. Co.	12/75	.11987	Other	199,580	220,696	Closed	195,734
	Security Fire & Cas.	12/75		Other	19,921	23,118	Closed	16,987
	Reserve Ins. Co.	6/80		W.C.	30,012	0	Open	63,476
		6/80		Other	37,824			
	Atlantic & Gulf States	6/80		Auto	274,967	0	Closed	197,809
				W.C.	75,030			
				Other	24,885			
	Summit Ins. Co.	12/75		Auto	19,727	18,899	Closed	5,064
	Proprietors Ins. Co.	1982		Auto	9,907			
				Other	45,583			50,833
SOUTH DAKOTA	Reserve Ins. Co.	5/81	.000046	Auto&Other	9,003	0	Closed	324
	*	5/81	.000044	Auto&Other	8,540			
	Proprietors Ins. Co.	10/81	.0008848	Other	99,940	0	Closed	63,076
	Manufacturers & Wholesalers	12/77	.0000869	Auto	49,425		Closed	42,507
	*Administrative Assessment Not Allocated To A Particular Insolvency							
TENNESSEE	LaSalle Nat'l. Ins.	2/72	.06	Other	255,457			
	Maryland Nat'l.	6/75	.04	Other	234,561			
	Summit Ins. Co.	8/77	.00021	Other	1,687			127,675
	Medallion Ins. Co.	5/78	.00026	W.C.		125,988		
	Reserve Ins. Co.	8/80	.0174	Other	208,691	154,364**	Open	207,781
	Proprietors Ins. Co.							
	Cotton Belt Ins. Co.							
	Gulf American	12/84	.000105	Other	150,000			

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

**prior insolvencies amount credited to Reserve assessments

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
TEXAS	Mobile Ins. Co.	10/75	.23899815	Auto	39,984	0		*
	Mobile County Mut. Ins. Co.	10/75	.23899815	Auto	1,999,292			*
		4/76	.13391402	Auto	1,076,125	0		*
		7/76	.21426201	Auto	2,400,525			
	Missouri General	10/75	.23899815		24,992	0	Closed	*
		4/76	.13391402	Other	25,027			
	Medallion Ins. Co.	10/75	.23899815	Auto	24,992			
		4/76	.13391402	Auto	250,262	0		*
		4/76	.00427739	W.C.	25,026			
	Summit Ins. Co.	10/75	.23899815	Auto	179,936			
		10/75	.10217763	Other	693,611	0		*
	Wisconsin Surety	10/75	.01703271	Other	297,315	0		*
	Interstate Ins. Co.	10/75	.01703271	Other	19,815	0		
	Manufacturers & Wholesalers Ind.	4/76	.13391402	Auto	175,183			*
		4/76	.01703271	Other	175,183	0		
	Reserve Ins. Co.			Auto	258,000		Open	
				Other	185,000			
	Proprietors Ins. Co.			Auto	336,000		Open	
				Other	143,048			
	Security Casualty			Auto	302,500			
				Other	140,000		Open	
	Kenilworth Ins. Co.			Auto	565,500			
				Other	25,000		Open	
	Lloyds of America			Auto	890,602		Open	
				Other	193,882			
	Equitable Exchange			Other	15,000		Open	
	Superior Lloyds						Open	

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

*indirect cost paid by receivership estate, amount collected from assessments covered direct costs

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
UTAH	Transnational	9/75	.001282	Auto	98,410	0	Open	10,084**
(based on		6/78	.0012507	Auto	21,772			
1980	Mobile Ins. Co.	NO ASSESSMENT		*			Open	953
figures)	Manchester Ins. Co.						Open	50,083
	Summit Ins. Co.						Open	504
	Medallion Ins. Co.						Open	18,095
	Manufacturers &						Open	
	Wholesalers Ind.						Open	10,764
	Signal Ins. Co.						Open	296
VERMONT	American Reserve/	9/79	.0002	Auto	79,950	0	Closed	90,777
	Reserve Ins. Co.		.0008	Other				
	Consolidated Mutual	1/79	.0030	W.C.	58,936	0	Closed	44,953
		1/79	.0001	Other				
	Southern American	8/76	.0002	Other	9,869	0	Open	10,073
	Fire Ins. Co.							
	Summit Ins. Co.	8/76	.0007	Auto	39,842	0	Open	16,739
		8/76	.0002	Other				
	Proprietors					0	Open	20,853
	Security Casualty					0	Closed	7,659
	Ambassador	10/84	.0008	Auto	746,151	0	Open	
			.0025	Other	249,838	0	Open	1,622,979
	Excalibur					0	Open	18,634
	Ideal					0	Open	
VIRGINIA	Security Casualty	12/81		Auto	unavailable at present time		Open	300,000 (approx.)
	Fauquier Mutual Fire Ins. Co.	9/81		Other	321,459		Open	343,248
	Proprietors Ins. Co.	NO ASSESSMENT					Open	65,905
	Reserve/Am. Reserve	12/80		Other	307,970		Open	8,198
	Aspen						Open	
	Ideal Mutual						Open	

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

* All Claims and expenses for all subsequent insolvencies have been paid from Transnational's account

** All figures for Utah reflect claims paid. It is estimated that $16,000 in outstanding claims and expenses are pending.

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
WASHINGTON	Summit Ins. Co.	7/75	.0004	Auto	128,079	0	Closed	126,430
		12/81						
	Transnational Ins.	10/75	.005	Auto	129,020	113,043	Closed	98,205
		12/81						
	Medallion Ins. Co.	10/75	.003	Auto	857,651			
		10/76	.0008	Auto	223,233	179,309	Open	987,929
	Manufacturers & Wholesalers	10/76	.0004, .0003	Auto	256,358	0	Closed	280,707
		10/81						
		10/76	.0004, .0001	Other	47,328			
		10/81						
	Signal Ins. Co.	6/78	.0002	Auto	99,753			
		6/78	.0003	Other	149,630	0	Closed	148,458
	Eldorado Ins. Co.	NO ASSESSMENT		Other	0	0	Open	42,164
	Reserve Ins. Co. & American Reserve	10/79	.0001	Auto	75,958	0	Closed	446,852
		10/79	.0007	Other	374,700			
	Proprietors Ins. Co.	8/81	.0008	Other	499,872	0	Open	475,622
	North-West Ins. Co.	12/84	.0008	Auto	698,045	0	Open	1,730,702
			.0004	Other	299,162	0	Open	741,729
WEST VIRGINIA	Summit Ins. Co.	4/77	.000085		10,132	7,106	Closed	9,349
	Professional Ins.	9/77	.0010103		118,439	0	Open	158,439
		11/79	.000318		40,000			
	Consolidated Mutual	11/79	.0000167		3,000	0	Open	3,000
	Reserve & Amer. Res.	11/79	.0001283		23,000	0	Open	23,000
	Church Layman Mutual	7/81	.0027	Other	585,589	0	Open	545,061
	Proprietors Ins. Co.	8/81	.00046230	Other	100,000		Open	100,000
	Security Casualty	12/81	.0023921	Auto	629,169	300,000	Open	629,169
	Excalibur	9/84		Auto	300,000		Open	300,000

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

State	Insolvent Company	Date	% of Premium Assessed	Account	Total Collected All Companies	Returned by Guaranty Funds To All Companies[1]	Insolvency Open/Closed	Projected Total Cost All Cos.[2]
WISCONSIN	LaSalle National	6/73	.005 direct premiums less dividend credits	Other	332,459	664,918	Closed	
		1/75	.005 direct premiums less dividend credits		332,459			
	Medallion Ins. Co.	10/78	Market Share x $1,000,000	Other	9,963	0	Closed	9,963
	Interstate Ins. Co.	10/78	Market Share x $1,000,000		146,589	0	Closed	140,000
	Wisconsin Surety Ins.	10/78	Market Share x $1,000,000	Other	401,255	0	Open	100,000
	All-Star Ins. Co.	10/78	Market Share x $1,000,000	Other	401,255	0	Open	100,000
		2/81		Other	381,625			
	Summit Ins. Co.	10//8	Market Share x $1,000,000	Other	40,227	0	Closed	25,000
	Reserve Ins. Co.	2/81		Other	202,950	0	Open	200,000
	Proprietors Ins. Co.	10/81	.000934	Other	1,494,877	0	Open	1,000,000
	Old Security Ins. Co.			Other	0	17,550	Closed	200,000
	Security Casualty Ins.	12/81	.000934	Other	1,494,898	0	Open	
WYOMING	Reserve Ins. Co.	11/79		Auto	98,110	0	Closed	92,045
		1/82		Auto		31,306		
	Proprietors Ins. Co.	9/82		Auto	29,460	0	Open	29,758
	Security Casualty Co.	9/82		Auto	0	9,820	Open	14,934

[1] includes amounts returned as liquidation dividends and excess assessments

[2] includes amounts paid and estimate of amounts needed to complete insolvency payments (direct and indirect costs) where available

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LIFE AND/OR HEALTH INSURANCE COMPANY INSOLVENCIES 1975 - MAY 1, 1985

COMPANY	DATE	STATE	ADMITTED ASSETS 1 OR 2 YEARS PRIOR TO INSOLVENCY (FROM BEST'S)	ESTIMATE[1] OF SHORTFALL
American Travelers LIC	1975	Tx.)		$6,000,000
National Fidelity Mutual	1975	Tx.)		
Source LIC	1975	Tx.)		
Seaboard Life	1975	Fla.		
Western American	1975	NM	6,271,174	4,000,000
Farmers National	1976	Fla.	10,319,106	
Northeastern Life	1976	NY	31,162,000	5,000,000
Conn. Comm. Travelers Mutual	1977	Ct.	2,310,075	2,257,854
Old Security Life	1977	Mo.	2,808,499	
Rainier National Life	1977	Wash.	1,983,000	
Commonwealth Ins. Co.	1978	PR	349,984	
Keystone Life	1978	Ind.	Not listed	
Natl. American Life	1978	La.	22,268,920	300,000
Fort Worth Life	1979	Tx.)	1,461,960)	1,840,000
General Protective Life	1979	Tx.)	272,000)	
Great Security Life	1979	Tx.)	197,000)	
Mutual Life Ins. of America	1979	Pa.	1,196,997	
Pilgrim Life	1979	Ind.	10,622,127	
Protective Life	1979	Wash.	893,000	
American Centennial	1980	Md.	4,967,408	750,000
Financial International	1980	NM	Not Listed	3,000,000
Old Heritage Mutual	1980	Pa.	Not Listed	300,000

[1] Estimated by Guaranty Association Boards of Directors or by Insurance Departments.

COMPANY	DATE	STATE	ADMITTED ASSETS 1 OR 2 YEARS PRIOR TO INSOLVENCY (FROM BEST'S)	ESTIMATE OF SHORTFALL[1]
Cibola Life	1981	NM	$ 3,129,395	$ 1,700,000
Western Investors	1981	NM	4,996,068	4,000,000
American Guaranty	1981	Tx.	4,097,433	3,000,000
United Capital	1981	Tx.	452,740	
Reliable Life & Casualty	1982	Wisc.	32,444,994	12,000,000
Bus. Ins. Life of America	1982	La.	1,130,787	2,000,000
Kokomo National Life	1982	Ind.	3,269,404	1,725,000
Fort Lincoln Life	1983	ND	1,280,009	8,000,000
Florida General	1983	Fla.	5,839,301	15,600,000
Gulf American[2]	1983	Fla.	Not Listed	2,100,000
United Bankers	1983	Tx.	15,380,228	13,000,000
Modern Life & Accident	1983	Ill.	756,195	2,500,000
Iowa State Travelers	1983	Iowa	10,637,711	55,000,000[3]
Georgetown	1983	Ill.	29,464,649	12,000,000
Independent Liberty Life	1983	Mich.	25,265,670	4,000,000
Tara Life	1983	Del.	7,641,988	3,800,000
Idaho Teachers	1983	Idaho	1,101,000	870,000
Security Casualty[2]	1984	Ill.	Not Listed	300,000
Liberty Investors LIC	1984	Okla.	9,563,285	5,000,000
United Equity LIC	1984	Okla.	2,518,000	6,000,000
Fin. Sec. Ins. Co., Ltd.	1984	Me.	10,678,478	1,300,000

[1] Estimated by Guaranty Association Boards of Directors or by Insurance Departments.

[2] Property/Casualty Company which requires assessment for Accident and Health Insurance.

[3] Revised Estimate by Receiver of Iowa State Travelers as of September 1984 (at time of insolvency estimated at $15,000,000).

STATEMENT FOR THE UNITED STATES SENATE
RELATING TO FEDERAL DEPOSIT INSURANCE

Submitted
By

GERALD F. FITZGERALD

CHAIRMAN, SUBURBAN BANCORP, INC.

RF
&R

Fifty-one years ago, the original intent of the legislation enabling the FDIC and FSLIC was to protect the small depositor from the immediate problems associated with bank failures. Up to now, this program has worked admirably protecting several hundred million depositors.

The amount insured has increased from $2,500 to $100,000 per account, and in effect now insures formally all the deposits of probably 98% of depositors and protects informally 99% of the depositors of small banks, and 100% of the depositors of large banks.

Problem of Mismanagement

Because it is now stated public policy that no large bank will be allowed to fail, market forces are prevented from disciplining mismanaged large banks. The $100,000 amount of deposit insurance per account has caused most depositors to have zero concern with the safety or soundness of their depository institution, refocusing their sights on where and how they can get maximum yield without the normal concern of risk.

In short, the blessing of deposit insurance has now become a curse of irresponsibility both for many institutions and most depositors.

Protecting the "System" and the Small Depositor

The concerns in the early 1930's centered around protecting the small depositor. Today the concern is protecting the small depositor as well as protecting the "system." The thought of a large bank failure and its consequences is unfathomable because of the unimaginable disruption it would cause with correspondent banks and countless corporations depending on payroll services and short-term operating funds.

We propose, therefore, that the Senate consider assigning two aims to future deposit insurance:

1. Protecting the "system"
2. Protecting the small depositor.

Money Movement

Hundreds of billions of dollars are swishing through the commercial banking system daily. Indeed, demand deposits are turning over more than twice daily in money center banks. This must be compared to our national average of a twice-monthly turnover before World War II. The time value of money over the past 40 years has become so great that bank users have found systems that allow them to move money more than 30 times faster than 50 years ago, and the pace is accelerating.

With new electronic techniques, it is possible for the same dollar to pay bills 500 times a day, ultimately 500 times a minute.

So the regulators are faced with the horror of what happens in a business day if a major bank should fail. In short, they can no longer allow a large bank to fail because of the unending repercusions to all other banks and businesses.

To secure the safety of the system, we believe that the FDIC should guarantee without limit

1. Demand deposits
2. Wire transfers
3. Inter-bank transfers and
4. One-day federal reserve funds.

This would mean all transaction account business would proceed normally, even in the event of a large bank failure.

Deductibles

Secondly, we believe that all deposits should be guaranteed 100% with a sliding scale of deductibles. In order to bring financial responsibility to the minds of the depositors, both large and small, deductibles should be started at $50,000 rather than $100,000. They could start at 10% for $50,000 and ultimately go to 20% for some higher figure. This device would allow major banks to fail -- a consequence very important for America. A major bank could fail without disrupting business, and the giant CD or note holders would bear losses beyond those of the shareholders, up to the limit of their deductible.

Discipline

Thus with a simple solution of insuring 100% of all demand deposits and federal reserve funds and all other deposits with deductibles, we would guarantee the safety of the system, allow banks of any size to fail as they should be allowed to do, and ultimately force discipline on the banks and their shareholders, investors and depositors. That discipline would be one of prudence, forcing the depositor to learn to read balance sheets, to care about the safety of their selected bank and worry more about safety than securing top interest rates.

Last year when the savings and loan industry was suffering greatly, it expanded by more than 20% at a time when prudence would dictate it contract. Current measures by the FSLIC demanding capital ultimately will be beneficial, but true regulatory or market discipline is still in the far future. Discipline then must be introduced by depositors and investors. Not enough bank examiners are available now, nor will they ever be, to force poor managers to behave. We must rely on market forces.

Responsibility

The $100,000 coverage of deposits is clearly too high. Many savvy investors, banks and insurance companies are pleased to buy $100,000 CD's in questionable financial institutions all over the country.

In what responsible investment can these institutions shopping for super-high rates place this money? The answer is of course "nothing responsible." So the $100,000 insurance coverage perpetrates speculative and doubtful investment actions all over the country, hurting the honest and responsible institutions and insurance funds while producing an orgy of speculation.

We are likely to see a "Gresham's Law" of bad banks develop, driving out good banks with United States government aid.

The proposal of variable rate insurance is needed with two criteria:

1. The rating of banks must be objective.
2. The punishment of higher premiums for poorly run banks and thrifts must be painful enough to elicit reform!

Capital Requirements

Both Chairman Paul Volker of the Fed and Chairman William Isaac of the FDIC have suggested that 9% is the appropriate capital level for banks. That level clearly will be destructive to the banking industry unless other competitors, including Sears Roebuck, are required to maintain 9% capital for their banking functions. Investment bankers run without comparable capital requirements. Thrifts are supposedly operating on 3% capital. All directly compete with banks. We would have no objection to the 9% capital requirements as long as all competitors have the same requirements.

Unfortunately, bank examiners look for the simplest possible way to do their job, and forcing the banks to have more capital certainly is much easier than learning to examine in depth the entire asset quality of a bank and then monitoring it.

We believe the likes of Sears and Household Finance should be allowed into the banking business providing they operate under the same government restraints as banks. Would Sears put up 9% capital to run a bank and maintain its reserve requirements? Unfortunately people on the periphery of banking are playing the game by different rules.

Off-Balance-Sheet Liabilities

The Federal Reserve and other examiners are absolutely correct in requiring capital for off-balance-sheet liabilities. Letters of credit, interest rate swaps and other devices designed to hold down asset growth as off-balance-sheet commitments should require capital.

Foreign Deposit Insurance

The pinnacle of folly is for small banks to pay insurance premiums on all their deposits while large banks (like the Continental) pay premiums on only their domestic deposits and yet have defacto insurance on their foreign deposits. This is a great injustice to banks that do not have foreign deposits.

Continental Bank Bail-Out

While I absolutely approve of the actions of the Administration and the regulators in bailing out the Continental, I question their current laissez faire attitude toward the Continental while it now uses the premiums made available by the banking industry to expand. The Continental, with a very questionable Camel rating, is building a 10-story banking facility in Elk Grove, Illinois with capital requirements greater than the entire deposit structure of our own competing bank. We now have a nationalized Continental Bank with unlimited ability to spend, if not taxpayers funds, the insurance reserves of their prudent competitors who didn't get themselves in trouble.

The injustices are quite apparent. While I don't believe the Continental should be liquidated, I believe that it should be shrinking continuously until its proportion of core deposits is higher than the now "Government guaranteed" hot money.

The October 7, 1985 American Banker ran a story saying that Continental plans to acquire other banks. I would, too, if I were Mr. Swearingen, whose only shareholder now is the FDIC, apparently putting no restraints on the Continental's future acquisitions. While I hope they would be viable, I find it inappropriate for the Continental to be bidding to acquire against those who have funded its rescue with FDIC funds.

The same, of course, could be said of nationalizing S&L's and other thrifts. While not suggesting that all those in trouble should be liquidated, it could be an appropriate suggestion if we are forced to continue to subsidize our failed competition. Paying once for your competitors' blunders should be enough. We shouldn't have to re-subsidize them.

Bank Capital and Inflation

No industry in America is more vulnerable to inflation's ravages than banks and thrifts. We are limited by law to holding monetary assets: other than our buildings, furniture and fixtures, we have nothing that will rise with price increases. Indeed, all our assets' values fall with inflation. Very clearly banks cannot earn capital as fast as the Fed can print money. Every time a billion dollars is printed, the banking system is $60 million short of capital. Continuous U.S. deficit financing unquestionably will destroy the banking system as it is currently constituted.

Branch Bankings and Interstate Banking

We welcome it! We are not afraid to compete and we think we can run circles around the muscle-bound monsters.

Finance Companies Unbundling

For years, the Justice Department massaged the computer industry to unbundle software from computer sales. We have a much more competitive and vigorous market since that has been done. I fail to understand why the Justice Department allows General Motors and Ford to make new auto loans under market rates to avoid lowering their auto prices. In addition to causing great disruption to commercial financial channels, it is basically bad public policy to put a floor under auto prices through this device.

Deregulation in General

Deregulation is beneficial because it forced us to be more competitive and to give the consumer a better shake. Everyone benefits except those who try to avoid competing. Deregulation has saved the railroad industry, revitalized the trucking and air transport industry, and should have long-term beneficial effects for the banking and thrift industries, giving the public more value for its hard-earned money. While I have no illusions that banks will ever be totally deregulated, nor should they, the results so far certainly justify the efforts.

JAKE GARN, UTAH, CHAIRMAN
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KENNETH A. McLEAN, MINORITY STAFF DIRECTOR

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510

October 23, 1985

Mr. H. Brent Beesley
Chairman of the Board and
Chief Executive Officer
First Charter Savings Bank
95 East Tabernacle
St. George, UT 84770

Dear Brent:

As you are aware, several of the witnesses in the first phase of the Committee's hearings on deposit insurance reform discussed the difficulties with RAP and GAAP accounting. Some suggested that a managerial or current value accounting system be adopted by federal regulators.

I am aware of the cyclical swings that such an accounting system would produce. However, the issue does seem to warrant some further consideration. Would such a confidential disclosure by depository institutions to the federal insurance agencies assist them in ascertaining their potential exposure of an institution's failure? Would the requirement help the primary supervisors communicate the need for improved asset liability management systems? Would collection of the data permit high level agency personnel to study other supervisory uses of the data, if any? If there are benefits to be derived, how should the data be collected to ensure confidentiality? Can or should it be phased in? These are important and complex questions. We would like to review these matters, but the nature of the issues makes it inappropriate to conduct a separate hearing on them.

Accordingly, I very much appreciate your willingness to chair an informal advisory group for the Senate Banking Committee. The remainder of the group will consist of agency personnel.

The purpose of the group is to increase the Banking Committee's understanding of the complex questions raised by current value accounting as well as a discussion of what further study should be done on the issues. We recognize that a final study is not possible nor are we seeking implied agency endorsement of the group's work.

What we are seeking is a thoughtful presentation of complex issues in the form of a white paper. It would be most helpful if your ad hoc committee could complete such a project by the end of January. Thanks again.

Sincerely,

Jake

Jake Garn
Chairman

JG:jbk

5828 Brentwood Drive
Salt Lake City, Utah 84121

February 12, 1986

Honorable Jake Garn
United States Senate
Committee on Banking, Housing
and Urban Affairs
Washington, D. C. 20510

Dear Jake:

I am pleased to deliver herewith three copies of *Current Value Accounting -- A Report to the Senate Banking Committee* as requested by your letter to me dated October 23, 1985. The other members of the discussion group you assembled for this project gave this project their full support, and I appreciated the opportunity to become acquainted and work with each of them.

The five member discussion group met six times over a four month period. The group first read and discussed several major studies that had previously considered the issue of current value accounting. Each member of the group then independently addressed in writing the specific questions raised by your letter. These responses were then circulated among and discussed by the group. The final report was drafted by the group with the exception of Section IV which contains the recommendations.

Although all the recommendations were discussed by the group, the agency members of the group elected not to participate in the drafting of Section IV. It is the understanding of the agency members that their respective agencies may be asked to comment formally on the report and that their principals might have other and different recommendations regarding current value accounting.

The focus you have brought on this most important topic is very timely. If this report can be educational to your Committee members and if it can be used as a catalyst for further discussion and debate, our efforts will have been well worth while. You will note that Section V. outlines our suggestions for further studies that you may wish to consider.

Hon. Jake Garn
Page 2
February 12, 1986

Jake, I appreciate the opportunity to have been involved in this project and would be pleased to answer any questions or provide any additional information you or other members of your Committee may desire.

Sincerely,

H. Brent Beesley

HBB/lm

Enclosures

CURRENT VALUE ACCOUNTING

A REPORT TO THE SENATE BANKING COMMITTEE

I. INTRODUCTION

By letter dated October 23, 1985, Senator Jake Garn, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, created an informal discussion group (the "Discussion Group") to aid in the preparation of a report to the Banking Committee that would increase the Committee's understanding of the complex questions raised by current value accounting ("CVA") and would discuss what further study might be done on these issues. Senator Garn's letter also contained several very specific questions to be addressed in this report.

This report does not represent the official position of any federal regulatory agency or of any particular member of the Discussion Group.

II. BACKGROUND AND PREVIOUS STUDIES

Financial reporting is intended to provide information that is useful in making business and economic decisions. Thus, an objective of financial reporting is to help investors, creditors, and others assess the amounts, timing, and uncertainty of an entity's prospective cash flows. Financial reporting accomplishes this by conveying information on an entity's economic resources and the claims on these resources as well as on the transactions and events that change them. Thus, financial accounting assists users in estimating the value of an entity rather than measuring its value directly and must do so by providing unbiased information.

The information produced by an accounting system should possess certain qualities to ensure its usefulness for decision-making. The two primary qualities are relevance and reliability, but the qualities of comparability and consistency must also be present. In addition, the benefits to be derived from financial information should exceed the cost of generating such information. It is upon this foundation that the present historical-cost based system of generally accepted accounting principles ("GAAP") has developed.

Because GAAP does not consider the unrealized gains and losses that result from holding financial instruments, there is a strong possibility that a firm's net worth presented in accordance with GAAP and its economic net worth will differ. Consequently, over the last several years, there has been increased concern over whether financial accounting, reporting, and disclosure by savings and loan associations and banks provide meaningful information to investors, depositors, regulators, and others.

The accounting profession has been very active in addressing the problems of the present system. The Financial Accounting Standards Board ("FASB") established an Emerging Issues Task Force in 1984 to promptly identify and define emerging accounting issues. Since its formation, almost half of the approximately 90 issues addressed by the Task Force have pertained to banks and thrifts. Also, at the urging of the Chief Accountant of the Securities and Exchange Commission and others, FASB is considering whether to add to its agenda a major project—dealing with the accounting treatment of financial instruments.

Recent pressure on the federal deposit insurance agencies has also increased the need for a more accurate system of financial accounting and reporting. There is the potential for extreme risk-taking by financial institutions that have a reported net worth but no real economic value. The managements of such institutions have sometimes taken the position that "there is nothing real to lose by rolling the dice." By the time GAAP net worth reaches the level where regulatory action is taken, losses to the insurance funds can become very large.

Consequently, accounting and reporting issues have recently become an important regulatory priority. As the need has arisen, each of the banking and thrift regulatory agencies has issued either regulations or policy statements pertaining to specific accounting and reporting matters. Furthermore, both the banking and thrift regulators have begun to require the institutions under their supervision to report certain data that assists in determining such institutions' sensitivity to changes in interest rates. Banks now report information on nonperforming loans as well.

As an alternative to the present historical cost-based system of accounting ("HCA"), a suggestion that has been explored periodically in recent years has been whether financial institutions should adopt some form of CVA. A number of studies have been conducted on this subject and a summary of the conclusions reached in each follows.

A. The Economic Impact of Alternative Financial Accounting and Reporting Models for Commercial Banks

This 185 page study, published in April 1978, was performed by Arthur D. Little, Inc., for the Inter-Association Committee on Bank Accounting. This study has interesting historical value as it was completed prior to the most recent period of interest rate instability which commenced in October 1979.

The stated purpose and conclusion of the study are as follows:

> The focus of this study was on banks in the capital markets, and the probable impacts of changing from the conventional, historical cost system of accounting and reporting to alternative models proposed for study. (page 1)

This study concludes that CVA has strong theoretical appeal but also has severe implementation difficulties. CVA can introduce considerable volatility and subjectivity into accounting presentations. CVA is criticized for having features of a liquidating value concept rather than the measurement of the elements of an on-going business. (see page 8)

> There is no strong concern or consensus among the users of bank financial statements to adopt another framework for financial accounting and reporting. Most are content with the historical cost system, given the expectation that further disclosure and supplemental data will be provided. They want to make their own adjustments to financial statements and embody their own forecasts in analyses; they feel that they can best continue to do this . . . by receiving additional disclosure and supplemental data from the bank management. (page 9)

B. Discussion Paper on Current Value Accounting

This discussion paper, dated January 14, 1983, was prepared for the Federal Financial Institutions Examination Council. The paper compares various accounting systems, outlines the relevant issues pertaining to these systems and describes initiatives regarding accounting issues being taken by regulators at that time.

This paper was intended to provide valuable background information and a description of the systems and issues. It does not contain conclusions or recommendations.

C. Current Value Accounting Studies

This report, dated August 2, 1983, was also prepared for the Federal Financial Institutions Examination Council and updated much of the information contained in the January 14, 1983 discussion paper referred to above.

The report also contains information on the impact of a full-scale application of CVA to securities holdings of institutions and an examination of the relationship between CVA and the submission of raw interest-rate sensitivity data.

The report contains the following background material on the "1938 Accord":

> The 1938 Accord was reached by the three federal banking agencies and the Secretary of the Treasury on June 17, 1938. The agreement's provisions included for the first time uniform examination procedures for the federal banking agencies regarding the classifications of loans and the treatment of changes in market value of bank securities portfolios and a revision of the investment securities regulations of the Comptroller of the Currency.
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> . . . a major feature [of the Accord] was a landmark agreement to discontinue the use of the current value method of accounting for the investment securities portfolios of banking organizations. . . . The supervisory agencies sought this

> change from current value accounting because CVA caused banks to operate in ways that restricted credit to the economy and inappropriately hindered economic growth. Because of the use of this accounting method, banks traded securities in ways that frequently caused bond price fluctuations that destabilized and depressed the bond markets. This occurred because the use of CVA forced banks to purchase securities for short term price appreciation - and not with a view to the underlying intrinsic value of the securities - in order to maintain their capital and earnings level. (pages 13 - 14)

While the regulatory authorities in 1938 believed that abolishing CVA was a useful policy response to conditions at that time, it is uncertain whether circumstances today would result in the same effects if CVA were to be reinstituted.

D. Report of the Expanded Task Force on Current Value Accounting

This 39 page report, dated April 12, 1983, was prepared for the Federal Home Loan Bank Board. The task force consisted for seventeen members with varying backgrounds and areas of expertise.

The task force concluded:

> [f]irst, it is imperative that financial institutions and their regulators come to understand the nature of interest

> rate risk and the consequences that interest rate volatility can have on the profitability and viability of individual institutions. Second, the current method of historical cost accounting for financial institutions does not, in many instances, accurately portray the economic substance of transactions being made, and . . . other accounting methods should be explored. (page 11)

While the task force urged the establishment of a limited pilot program to test the implementation of a current value accounting system, no such program has been established.

E. Guidance for an Experiment on Reporting Current Value Information for Real Estate

This 50 page report, dated December 31, 1984, was prepared by the Real Estate Accounting Committee, Accounting Standards Division, American Institute of Certified Public Accountants.

The paper states that:

> [s]upplemental reporting of current value information by real estate companies has increased during the past five years, primarily because many believe that financial statements prepared on the basis of present generally accepted accounting

> principles (GAAP) do not reflect the unique economics of investments and other interests in real estate.
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> Many argue that financial statements that present information on values, changes in values, and operating cash flows of real estate are more relevant to users such as lenders and investors. They believe that, because current value financial statements are based on current economic data, such statements are more useful than those prepared based on historical costs in assessing a company's current financial position, operating performance, and liquidity (cash-flow prospects and borrowing and dividend-paying capabilities). (page 5)

The paper contains guidelines for the experimental presentation of current value information in the financial statements of real estate companies.

(A copy of each of these studies is included in Appendix B which is separately bound.)

III. ANSWERS TO SPECIFIC QUESTIONS REGARDING CURRENT VALUE ACCOUNTING

A. What is the difference between current value accounting and the accounting system currently in use?

The present system of generally accepted accounting principles is based on historical costs. According to GAAP, most assets and liabilities are carried on the books of the institution at values related to the prices that were paid for the assets or the monies that were received for the liabilities. If market conditions change, adjustments are not normally made on the books of the institution to reflect the changes in the economic values of assets and liabilities. Further, GAAP does not consider the rate or maturity of assets or liabilities. For example, a loan made for $100,000 at a rate of 18 percent with a term of twenty years and a loan made for $100,000 at a rate of 7 percent with a term of five years are both carried at a value of $100,000 despite the fact that their respective market or current values are quite different. Likewise under GAAP, a loan to a AAA-rated company and an otherwise identical loan to a B-rated company would be treated as having the same value.

Current value accounting is based on the notion that all assets and liabilities should be carried at their respective market values or at values that approximate market values if no market exists. CVA is currently used in the brokerage industry where certain assets and liabilities are repriced each day to reflect current market values.

There are three general sources of distortion between CVA and HCA.

1. The first distortion results from changes in interest rates. This distortion can be very significant for institutions that have long-term assets or liabilities. For example, the market value of a U.S. Treasury bond with an 8 percent coupon and 20 years to maturity has varied from a

high of over 100 in 1977 to a low of less than 56 in 1981. Under GAAP, the amount at which this bond would be carried on the books of an institution would be based on the price that the institution paid for the bond. One bank or savings and loan may have initially recorded the bond on its books at 56 while another bank or savings and loan owning an identical bond from the very same issue may have recorded it on its books at 100. With GAAP and HCA, the value at which the bond is reflected on financial statements at dates subsequent to its purchase depends on the price of the bond at the time of purchase. With CVA, the relevant number is the market value of the bond at the time the financial statements are prepared.

2. The second distortion results from the effects of price inflation on the value of fixed assets. This distortion is generally minor for financial institutions as fixed assets comprise a small portion of the institutions' balance sheets. (The FHLBB has recently allowed savings and loans to carry their office facilities at appraised value rather than historical cost less depreciation. This provision allows those savings and loans which are not concerned about complying with GAAP to keep their buildings and book the appreciation. Several financial institutions have recently entered into sale-leaseback transactions involving their headquarters buildings which enabled them under GAAP to recognize the appreciation related to the portions of these

buildings occupied by others. Although these institutions' GAAP net worths changed substantially after these sale-leasebacks, there would have been no change in their net worths based on CVA as the buildings would be carried already at their market values.)

3. The third distortion results from changes in the quality (collectibility) of assets. GAAP accounting requires that the value of assets be adjusted to reflect appropriate allowances for expected losses. The estimation of such losses is a judgmental process and a number of institutions have been found to understate their estimates, resulting in an overstatement of their earnings. Asset quality considerations would enter CVA via one of two alternative means. Under one alternative, changes in market values would result from changes in credit quality as well as changes in interest rates. Under the second alternative, CVA would reflect only the effects of changes in interest rates while changes in credit quality would be provided for through allowances for expected losses as is done under GAAP.

B. How is current value accounting done? Is it an expensive and difficult process?

Current value accounting could be introduced at various levels of formality. Establishing and maintaining a full CVA financial reporting system as a substitute for the present HCA reporting system would be exceedingly more difficult and expensive because the values of assets and liabilities under CVA must be constantly changed to reflect market conditions. Where there are no established markets, asset and liability values would have to be determined from appraisals and evaluations which are costly and time-consuming.

At a less formal level, CVA could be adopted to provide data to the regulatory agencies that would supplement HCA financial information. Under this approach, assets and liabilities for which there are no established markets could be valued by using market instruments as surrogates. For example, if an auto loan with X price and terms can be sold on the market for $5,000, a loan of similar credit quality and with the same X price and terms on a boat may be reasonably valued at $5,000. Market prices could also be used to determine a proper discount rate for long-term assets and liabilities. If the average yield on BBB corporate bonds with X maturity is 14 percent, then perhaps a loan to a local hardware store with the same X maturity could be reasonably discounted to yield 14 percent.

Moreover, many advocates of CVA suggest that assets and liabilities with a maturity of less than one year be carried at their face or principal amount. While this convention would reduce the accuracy of the CVA system to a limited degree, it would significantly reduce the cost and difficulty associated with implementing CVA. For example, a large percentage of the assets and liabilities of most commercial banks are short-term and would therefore not have to be adjusted to market value.

Another complication of CVA that has to be addressed is whether any liabilities should be carried at less than their principal amount. It is theorized that liabilities will have to be repaid by the federal deposit insurance agencies at their face amount in the event of a failure. However, there have been numerous cases where the liabilities of failed firms have been assumed at substantial discounts.

C. Would the disclosure of current value accounting data on a confidential basis by depository institutions to the federal insurance agencies assist the agencies in ascertaining their potential exposure to the failure of such institutions?

Accurate and timely data is essential in estimating the cost of resolving failures and in selecting the most efficient method to be used in resolving failures. With a few exceptions, both the FDIC and the FSLIC are required by statute to liquidate a failed institution unless a less costly solution can be found. The cost of liquidation cannot be calculated without information regarding the current values of the assets and the liabilities.

Existing procedures at the FDIC and the FSLIC require an examination or visitation to be conducted near the time of expected failure to ascertain the current values of assets and liabilities. This information is assembled in order to provide information on the failed firm to potential acquirers or managers. Both the FDIC and the FSLIC would likely be reluctant to rely exclusively on current value estimates provided by the failing firm as the basis for agency action.

The real usefulness of CVA to the deposit insurance agencies, however, would lie in the measurement of their exposure to institutions when they begin to experience serious problems instead of at the time when insolvency on a GAAP basis is imminent. To minimize losses to the deposit insurance agencies, an institution should be closed or taken over at the point when its current value net worth reaches zero. At present, the chances that the regulators can identify an institution at the moment it becomes economically insolvent are quite small. If examinations were triggered by assessments of net worth on a CVA basis, however, the likelihood of a timely closing or takeover would be improved.

D. Would the requirement for current value accounting help primary supervisors communicate the need for improved asset/liability management systems to financial institutions?

The use of CVA by financial institutions would likely promote improved asset/liability management because the results of any duration mismatch would appear in an institution's income statement in a dramatic fashion as the interest rate environment changes. Many institutions have begun to employ systems to effectively measure and control interest-rate risk while maintaining their adherence to GAAP. Regulators have also developed reports and analytical systems to perform a fairly basic evaluation of data supplied by institutions on their asset/liability positions. The data requirements for these systems are similar in many respects to, but not as extensive as, the underlying data requirements for CVA. In addition, as part of the examination process, examiners routinely review the asset/liability management policies of banks and thrifts and comment on any deficiencies they find.

E. Would collection of CVA data permit high level agency personnel to study other supervisory uses of data, if any?

The primary supervisory benefit that CVA data offers is the possibility of improved off-site monitoring of institutions' exposure to risk. Banks and savings and loans would in effect be reporting the level of their real net worth on a periodic basis. This data would be of use in determining the federal deposit insurance agencies' exposure to loss and, thus, would perhaps result in earlier closings and a less costly management of failures.

F. If there are benefits to be derived from CVA, how should the data be collected to ensure confidentiality?

There is no consensus that information pertaining to the financial strength of a depository institution should be kept confidential. There is some question as to whether sensitive data contained in reports of condition submitted by institutions can be kept confidential. Actions brought under the Freedom of Information Act might result in the public disclosure of such data.

Examination reports are not subject to the Freedom of Information Act and, with some exceptions, the agencies have been successful in maintaining the confidentiality of these reports. If raw data is submitted to the regulators as part of a CVA reporting system, the data may well have to be disclosed; however, agency manipulations of such data and the conclusions reached by the regulators may not be subject to mandatory public disclosure.

G. Can CVA be phased-in?

A major structural change in the financial accounting and reporting system for depository institutions would require a lengthy phase-in period. To the extent that the rate sensitivity data now reported by banks and thrifts is also necessary for CVA reporting, the initial step toward CVA is in a sense already in place. Moreover, GAAP already requires financial institutions to report the assets in their trading accounts on a current value basis and to disclose the market values of investment securities. A logical next step could be to begin carrying investment securities at current values. This would result in some immediate improvement in the reported data, yet would be relatively easy and inexpensive to accomplish.

As the next stage in a change to CVA, and to overcome the criticism that CVA is necessarily more subjective than HCA, the following approach could be considered. Those assets which have well-developed secondary markets (other than trading account assets and investment securities which would already be on CVA basis) could be marked to current market value. For those types of assets without such well-defined market prices, valuation could be accomplished by assuming that all principal and interest payments would take place according to schedule (adjusted for appropriate prepayment assumptions). Their cash flows could then be discounted at an appropriate rate to calculate the asset's present value under repayment certainty. Assets with identified deterioration in credit quality would be kept on the CVA books as though no repayment problems existed; however, a valuation allowance (loss reserve) with an adequate balance would be required. This treatment of credit quality problems is exactly parallel to what is currently practiced under HCA. Subjectivity enters through the process of maintaining the allowance account at an adequate amount, but this gives managements no more latitude for subjectivity than they currently have in maintaining adequate valuation allowances (loss reserves).

H. Should CVA or GAAP be required for financial institutions?

Financial institutions should maintain their financial statements in accordance with GAAP for the following reasons:

1. GAAP is, as the name implies, "generally accepted" in spite of its obvious weaknesses. An abandonment of GAAP would be viewed with concern by most users of financial information.

2. Given the absence of market values for many assets and liabilities and the lack of tested standards of evaluation, the potential for inconsistencies, error, and fraud in the preparation of CVA financial statements substantially reduces the level of reliance that can be placed on CVA reports.

3. There are available means to accomplish most of the benefits of CVA without the potential implementation problems of CVA financial statements.

4. Supplying raw CVA-type data to regulators will allow the regulators to consistently and systematically apply their own

valuation assumptions to the financial statements of banks and thrifts without relying on managements' opinions of values or without having to prescribe detailed regulations regarding valuation standards. This will also substantially reduce the concern over the confidentiality of CVA data as the regulators will convert the raw data into their own "in house" current value reports as needed. Moreover, the amount of CVA-type data the regulators require from individual institutions could be dependent on their characteristics. More detailed information could be collected from institutions with significant amounts of long-term assets or liabilities and from those already identified as experiencing serious problems, enabling regulators to more accurately assess the economic net worths of such institutions without imposing the added costs of larger amounts of CVA data on all institutions.

IV. RECOMMENDATIONS FOR NEW REGULATION AND LEGISLATION

Regulators must not be compelled to wait for GAAP net worth to approach zero or some other arbitrary level before appropriate action is taken to protect the insurance fund when it is clear that the real economic net worth of the institution has been lost. Federal regulators must have the authority to obtain relevant information regarding current values of both assets and liabilities. They must also have clear authority to make adjustments to net worth as reported in accordance with GAAP. Therefore, this report makes the following recommendations:

A. All financial institutions subject to federal regulation should be required to submit supplementary schedules to their regulators in sufficient detail to allow their respective regulators to make a determination of the economic net worth of the institution and the prospects for future viability. This would include data regarding the following:

1. The rate and maturity of longer-term assets and liabilities,
2. The value of fixed assets, and
3. The quality and collectibility of loans and investments.

B. Regulators should be given specific authority to adjust the reported net worth of a regulated institution to reflect the real economic value of the net worth of the firm. This adjusted net worth is hereinafter referred to as "Adjusted Capital."

C. Regulators should be given the specific authority to promulgate regulations based on Adjusted Capital. For example, the FHLBB presently has adopted several regulations which require thrifts with capital to asset ratios of less than three percent to refrain from various activities. The FHLBB should be given the authority to use Adjusted Capital for such regulations.

D. Regulators should be given the specific authority to merge or close institutions that fail to maintain an adequate level of Adjusted Capital.

E. Each of the above authorities should be discretionary.

The above authorities would allow the regulators to move cautiously and carefully toward a standard based on more meaningful accounting data. As regulators begin to focus on Adjusted Capital, it is anticipated that managers and accountants would be compelled to pay more attention to measures of current value and that GAAP would evolve more rapidly toward the use of current values.

The use of Adjusted Capital by regulators would provide greater impetus for institutions to reduce credit and interest-rate risk. It is also anticipated that the regulatory use of Adjusted Capital would reduce the present incentive of some managers to take actions that are driven by accounting considerations only and which may have deleterious effects on the economic value of the institution.

V. RECOMMENDATIONS FOR FURTHER STUDY

Due to the recent decline in interest rates, the long-term bond and mortgage portfolios of many institutions have a market value in excess of historical cost. This provides a good environment for open discussions of CVA versus HCA.

It seems clear that further study is required and is presently ongoing. Congress should continue to press for more information on this matter and solicit the opinions of various experts in public hearings.

FASB should be asked to provide a report on the issues it is addressing as they pertain to the regulated financial institutions.

Federal regulators should be asked to report on the measures they have taken and are considering to address the inadequacies of GAAP and HCA.

Another informal advisory group of professional accountants that practice in the financial institutions area should be organized to present their views on the same topics reviewed by this Discussion Group.

CONCLUSION

The public and regulatory financial statements of banks and savings and loans should be prepared in accordance with GAAP. GAAP is expected to evolve over time toward more CVA. This process should be encouraged, and further study and hearings on the topic are required.

Financial institutions should disclose to their regulators (and eventually to the public) sufficient raw data to allow the users thereof to prepare reasonably accurate and timely CVA statements of condition. Regulators should be given the authority to act based upon their calculations of Adjusted Capital as determined by CVA.